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SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1821

TO AMEND THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 WITH RESPECT TO THE TREATMENT OF MORTGAGE BACKED SECURITIES, TO INCREASE THE AUTHORITY OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION, AND FOR OTHER PURPOSES

S. 1822

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO ENCOURAGE INVESTMENTS IN MORTGAGE-BACKED SECURITIES THROUGH TRUSTS FOR INVESTMENTS IN MORTGAGES, AND FOR OTHER PURPOSES

S. 2040 (as reported)

TO AMEND THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 WITH RESPECT TO THE TREATMENT OF MORTGAGE BACKED SECURITIES, TO INCREASE THE AUTHORITY OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION, AND FOR OTHER PURPOSES

SEPTEMBER 21 AND 22, 1983

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

WEDNESDAY, SEPTEMBER 21, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 9:35 a.m., in room SD-538, of the Dirksen Senate Office Building, Senator John Tower (chairman of the subcommittee) presiding.

Present: Senators Tower, Gorton, Proxmire, Riegle, and Dodd.

OPENING STATEMENT OF SENATOR TOWER

Senator TOWER. The committee will come to order.

This morning the Subcommittee on Housing will begin consideration of S. 1821, the Secondary Mortgage Market Enhancement Act of 1983. This important legislative proposal was introduced together with S. 1822, the Trust for Investment in Mortgages Act of 1983, in order to enhance the environment for the expansion of the secondary market by encouraging the involvement of the private sector.

Although the focus of our sessions today and tomorrow morning will be on S. 1821, I am confident that the cumulative impact of both S. 1821 and S. 1822 will be significant on the marketplace and will ultimately work to the direct and significant benefit of home buyers in terms of increased availability of mortgage capital and lower interest rates on mortgages.

During our hearings in the spring of this year the subcommittee found that new sources for mortgage money must be found as more and more demands are placed on the credit market and mortgage lenders. Due to the magnitude of the demand for mortgage credit, the existing Federal agencies simply will be unable to provide all of the liquidity for mortgages that will be required during the coming decade. For the consumer this scarcity would mean that mortgages would cost more and be more difficult to obtain.

Clearly, action was required to prevent this scarcity from developing. As lawmakers, we have an obligation to take every responsible step in our power to make it possible for Americans to buy their own homes. Allowing the private sector to furnish the needed capital for home mortgage liquidity is an important step toward that goal.

I will hasten to add, however, it is the activity of FNMA and FHLMC in creating secondary mortgage markets, standardizing products and procedures and underpinning mortgage activity at the lower end of the market that has contributed significantly to the development of a private secondary market. I would further emphasize that nothing this committee is contemplating would diminish the importance of the role played by these two agencies.

Today we'll hear from several of the private sector firms which have begun to make inroads in providing mortgages an alternative route into the public secondary market. Although much of their activity has been limited, the effect of deregulation which has taken place in the financial marketplace, coupled with the efficiency and commitment of these firms, has resulted in private mortgage securities which are trading at interest rates closely approaching those of FNMA and FHLMC passthrough.

The primary intent of S. 1821 is to continue the process of deregulation which has led to a smoother operating and lower yields. This will be achieved by removing the remaining regulatory impediments which prevent mortgage pass-through securities from trading at least as well as other corporate securities.

The subcommittee welcomes the comments and suggestions of our witnesses today as they represent the broad range of interests within the housing industry which will be impacted by this legislation.

We have benefited greatly from the ongoing dialog between our subcommittee members and the representatives of these organizations and trust that today's panels will provide us with a valuable perspective on the specific provisions of this legislation. I would like to thank those who participated in the formulation of this legislation and hope they will continue to offer advice and counsel when the Finance Committee begins consideration of S. 1822.

The Trust for Investment in Mortgages Act of 1983 is of equal importance as it represents a means of broadening investor interest in private mortgage-backed securities. Let me indicate strongly that the subcommittee will not be contemplating significant changes to FNMA or FHLMC's charter act during the remaining months of this legislative year. Although it's imperative that we attempt immediately to improve the climate for the private sector, the role and the appropriate course for the public sector is less certain and demands specific and thoughtful consideration.

The issues which have been raised regarding FNMA and FHLMC are delicate and intricate and the subcommittee will continue to devote its efforts to resolving these points during subsequent sessions.

I would like to welcome our witnesses, our participants today, and yield to Senator Riegle for any comment that he may have.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

I, too, want to welcome our distinguished witnesses today and all the panels. Today's hearing concerns one of the most challenging problems before this subcommittee and that is how to insure that there will continue to be an adequate supply of funds for home mortgages while the country's housing-finance industry is undergoing historic changes.

While this problem will undoubtedly remain high on the subcommittee's agenda for many months, the bill that is now before us could be a modest, positive step toward a solution. This legislation is intended to foster the development of the private secondary mortgage market and I strongly support that objective.

The bill, fortunately, does not include some of the radical suggestions of some members of the administration that we terminate the Government's role in the current housing-finance system. I'm very pleased with that because I think the current system is working quite well to support the housing recovery and I don't think it should be weakened.

I understand that several improvements to the bill are being contemplated. I would suggest that the committee be guided by four principles as we shape and refine this bill.

First, the public policy should encourage private firms to issue mortgage-backed securities. The need will be enormous. Some estimates suggest that mortgage-backed securities will have to supply 75 percent of all housing credit by 1990. American home buyers I think will benefit by having the largest possible number of firms in the market.

Second, until the strength of the private market is developed, I think Congress should avoid any weakening of the ability of GNMA, FNMA, or FHLMC to provide funds for home mortgages and to respond to changes in the market.

Third, Congress should make those changes in the law that would help insure that housing finance is available at reasonable rates for modestly priced homes in all parts of the country and throughout the business cycle.

Fourth, of course, we've got to make sure that we are protecting the interest of individual investors.

I believe that the bill now before us can be refined so it can receive broad bipartisan support at an early date and I look forward to hearing the views of our witnesses, and I thank the chairman.

Senator **Tower**. Thank you, Senator Riegle.

Senator Proxmire, do you have any comments?

Senator **Proxmire**. Yes, I just have a brief comment I'd like to make, Mr. Chairman.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Mr. Chairman, first, I congratulate you and Senator Garn for offering this bill. I'm just jealous as the dickens that we didn't offer it earlier. We should have. It's overdue. It's an excellent bill and I'm delighted to be a cosponsor of it.

We need urgently to broaden the market for mortgages. As we all know, pension funds amounting to about half a trillion dollars, $500 billion or more, only invest about 2 or 3 percent of their funds in mortgages now. They obviously prefer bonds instead of mortgages. This would give mortgages, by putting them in a pool, a greater degree of liquidity, and make them much more attractive to pension funds and open up this very large investment source.

In addition to that, I also agree that we ought to have another backstop to the mortgage market in addition to FNMA and FHLMC.

At any rate, we're in some danger of having the Federal Government guarantee the entire housing sector and I think that would be a mistake.

I'm also concerned about the possibility of increased lending ceilings for FHLMC and FNMA that might inhibit the growth of the private secondary market. I think it's most significant that we have an excellent and broad group of witnesses appearing this morning. The first three witnesses represent a new initiative in this area. We've got Sears, General Electric, and a new group in Minneapolis that are getting into this, and they're mighty welcome.

So I once again congratulate the chairman and want to indicate my enthusiastic support for this action.

Senator TOWER. Thank you, Senator Proxmire.

Senator Dodd.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Thank you, Mr. Chairman.

Let me just add to what has been said by my two colleagues, as well as the chairman, and commend you for your efforts in developing this legislation which is the subject of today's hearing. It's certainly a very complicated and technical subject but there's a clear and overriding need for this and other measures to strengthen and expand the secondary mortgage market. With the increasing deregulation, financial institutions and instruments, more primary lenders will depend on the secondary market for mortgage capital. With or without further deregulation, we're likely to face a shortage of capital in the future unless new or expanded housing finance tools are developed to compete in the capital markets for nontraditional sources of funds. I think all of us recognize that without any question at all. We must encourage greater private savings and investment in socially and economic productive areas such as housing.

I'm sure there's nothing more disturbing to any member of this committee, regardless of which side of the table we sit on, than the recent news that since 1980 we have seen the first downturn in homeownership after 40 years of progress. And while these are important reasons to support the legislation, I'd like to signal my concern, Mr. Chairman, for two disturbing issues underlying this debate.

First is an enhanced expanded secondary market must not depend on a test of political muscle between worthy emerging private entities and the agencies and organizations which have and will be required to serve our housing finance needs. My concern is that there will be a contest of will in this town of who would emerge victorious in that battle. I would hope this wouldn't dominate the debate. We've got to seek a consensus which has as a result more and affordable housing for American people. I would urge the various parties involved in this subject to bring us to such an understanding. In my brief eight or nine years on this hill, I've become concerned about the potential for congressional inaction on any issue without some external consensus. I think it's going to be extremely important for us here to have some sense of consensus with the private organizations and with the public entities to try and come to some sort of consensus if at all possible.

Finally, we can't pursue one element of our housing needs without attention to the broader concerns, and I know for a fact that the chairman wants to pass a housing authorization bill as much as I do and I would suggest that despite our support for the proposal before us today we may be wasting our time if we can't find a way to break the current stalemate on the housing bill. I want him to know certainly that he can count on my support on both counts.

I appreciate the opportunity to comment, Mr. Chairman.

Senator TOWER. Thank you, Senator Dodd. I thought the issue of the housing authorization bill might come up. As you know, we did get that up on the floor last June and kept it on the floor for a little while and then because of the obstacles thrown in the way of further consideration we had to pull it down. I will assure you that I will do everything that I can, as I did in June to get it up in the first place, to try to get the authorization bill out. Hopefully, we can act on it. If we fail to, I hope that in connection with the time extension of FHA programs that perhaps we can at least tack on some of the things on which there is a consensus agreement and we can get it passed. In any case, I think we should leave no avenue unexplored until we get some kind of housing authorization legislation through this year.

Senator DODD. Thank you, Mr. Chairman.

[Copy of bills being considered follows:]

98TH CONGRESS
1ST SESSION

S. 1821

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the treatment of mortgage backed securities, to increase the authority of the Federal Home Loan Mortgage Corporation, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 4 (legislative day, AUGUST 1), 1983

Mr. GARN (for himself and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the treatment of mortgage backed securities, to increase the authority of the Federal Home Loan Mortgage Corporation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Secondary Mortgage Market Enhancement Act of 1983".

TITLE I—SECURITIES LAWS AMENDMENTS

REGISTRATION EXEMPTION

SEC. 101. Section 4(5) of the Securities Act of 1933 is amended to read as follows:

"(5) transactions involving offers and sales of one or more promissory notes—

"(A) which are directly secured by a first lien (or a second lien where the proceeds of the note were applied to the purchase of the security property or to improvements thereon) on—

"(i) a single parcel of real estate (including stock allocated to a dwelling unit in a residential cooperative housing corporation) upon which is located a dwelling or other residential or commercial structure, or

"(ii) a residential manufactured home, as defined in section 501(e) of the Depository Institutions Deregulation and Monetary Control Act of 1980,

and participation interests in such notes or mortgage related payment bonds secured by such notes or participation interests; and

"(B) where (i) the sales price for such note, participation interest, or mortgage related payment bond is not less than $250,000 or such note, participation interest, or mortgage related payment bond represents a participation interest or denomination which, if sold on the initial sale date, would have been sold for at least $250,000 based upon the percentage of principal represented by the initial sales price, (ii) the purchaser pays cash upon the earlier of (I) the date of delivery of such note, participation interest, or mortgage related payment bond, or (II) 120 days after the date upon which the purchaser committed to make such purchase, and (iii) such note or notes were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority or were originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 203 and 211 of the National Housing Act.

For the purpose of subparagraph (A), a mortgage related payment bond means an obligation (which may be with or without recourse to the issuer thereof) which, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the above requirements or participation interests therein which are pledged as security for such obligation and which are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.".

EXTENSION OF CREDIT

SEC. 102. Section 11(d) of the Securities Exchange Act of 1934 is amended by inserting "or securities described in section 4(5) of the Securities Act of 1933" after "exempted security" each place it appears.

NET CAPITAL REQUIREMENT

SEC. 103. Section 15(c)(3) of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following: "In establishing such requirements, the Commission shall accord the same treatment to securities described in section 4(5) of the Securities Act of 1933 which are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization as the treatment accorded in the case of securities described in section 3(a)(2) of such Act.".

INVESTMENT BY DEPOSITORY INSTITUTIONS

SEC. 104. (a) Section 5(c)(1) of the Home Owner's Loan Act of 1933 (12 U.S.C. 1464(c)(1)) is amended by adding at the end thereof the following:

"(S) MORTGAGE BACKED SECURITIES.—Investments in securities described in section 4(5) of the Securities Act of 1933, subject to such regulations as the Board may prescribe.".

(b) Section 107 of the Federal Credit Union Act (12 U.S.C. 1757) is amended—

(1) by redesignating paragraph (15) as paragraph (16); and

(2) by inserting after paragraph (14) the following:

"(15) to invest in securities described in section 4(5) of the Securities Act of 1933, subject to such regulations as the Board may prescribe.".

SECURITIES ACTIVITIES OF NATIONAL BANKS

SEC. 105. Section 5136 of the Revised Statutes (12 U.S.C. 24) is amended by adding at the end of paragraph Seventh the following: "The limitations and restrictions contained in this paragraph as to an association dealing in, underwriting, and purchasing for its own account investment securities shall not apply to securities described in section 4(5) of the Securities Act of 1933, subject to such limitations as the Comptroller of the Currency may prescribe.".

PREEMPTION OF STATE LAW

SEC. 106. (a) Any person, trust, or organization created pursuant to or existing under the laws of the United States or any State shall be authorized to purchase, hold, and invest in securities which are described in section 4(5) of the Securities Act of 1933, without regard to the requirement of subparagraph (B)(i) thereof, but which are registered under section 6 of such Act, to the same extent that such person, trust, or organization is authorized under any applicable law to purchase, hold, or invest in obligations issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. Where State law limits the purchase, holding, or investment in obligations issued by the United States by such a person, trust, or organization, such securities described in section 4(5) of the Securities Act of 1933 shall be considered to be obligations issued by the United States for purposes of the limitation.

(b) The provisions of subsection (a) shall not apply with respect to a particular person, trust, or organization or class thereof in any State which, prior to the expiration of 2 years after the date of enactment of this Act, enacts a statute which specifically refers to this section and either prohibits or provides for a more limited authority to purchase, hold, or invest in such securities by such person, trust, or organization or class thereof than is provided in subsection (a). The enactment by any State of any statute of the type described in the preceding sentence shall not affect the validity of any contractual commitment to purchase, hold, or invest which was made prior thereto.

SHELF REGISTRATION

SEC. 107. The Securities and Exchange Commission shall, by rule or regulation, provide for the registration pursuant to section 6 of the Securities Act of 1933 of securities which are to be offered on a delayed or continuing basis in the future, and which meet all the requirements of section 4(5) of the Securities Act of 1933, except for the requirement of subparagraph (B)(i).

TITLE II—FEDERAL HOME LOAN MORTGAGE CORPORATION AND FEDERAL NATIONAL MORTGAGE ASSOCIATION AMENDMENTS

FEDERAL HOME LOAN MORTGAGE CORPORATION PREFERRED STOCK

SEC. 201. Section 306(f) of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof the following: "Such preferred stock may have such rights as are permitted by the rules of the New York Stock Exchange in the case of securities listed on such Exchange.".

FEDERAL NATIONAL MORTGAGE ASSOCIATION PREFERRED STOCK

SEC. 202. (a) The first sentence of section 303(a) of the National Housing Act is amended to read as follows: "The corporation shall have common stock, without par value, which shall be vested with voting rights, each share being entitled to one vote with rights of cumulative voting at all elections of directors.".

(b) Section 303 of such Act is amended by adding at the end thereof the following:

"(h) Any preferred stock of the corporation may have such rights as are permitted by the rules of the New York Stock Exchange in the case of securities listed on such Exchange.".

(c) Section 308(b) of such Act is amended by striking out the word "common" in the first sentence.

FEDERAL HOME LOAN MORTGAGE CORPORATION PURCHASE OF JUNIOR LIENS

SEC. 203. The first sentence of section 302(h) of the Federal Home Loan Mortgage Corporation Act is amended by striking out "status as a first lien" and inserting in lieu thereof "priority of lien status".

FEDERAL HOME LOAN MORTGAGE CORPORATION MANUFACTURED HOUSING LOANS

SEC. 204. Section 302(h) of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof the following: "The term 'residential mortgage' also includes loans or advances or credit secured by mortgages or other liens against manufactured homes whether the security property is real, personal, or mixed.".

FEDERAL HOME LOAN MORTGAGE CORPORATION AUTHORITY TO PURCHASE STATE AGENCY INSURED MORTGAGES

SEC. 205. Section 302(i) of the Federal Home Loan Mortgage Corporation Act is amended by striking out "a State or an agency or instrumentality of either" and inserting in lieu thereof "any of its agencies or instrumentalities".

FEDERAL HOME LOAN MORTGAGE CORPORATION GUARANTEE OF MORTGAGE-BACKED SECURITIES ISSUED BY OTHERS

SEC. 206. Section 306 of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof the following:

"(h) The Corporation may not guarantee mortgage-backed securities other than mortgage-backed securities issued by the Corporation.".

98TH CONGRESS
1ST SESSION

S. 1822

To amend the Internal Revenue Code of 1954 to encourage investments in mortgage-backed securities through trusts for investments in mortgages, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 4 (legislative day, AUGUST 1), 1983

Mr. GARN (for himself and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to encourage investments in mortgage-backed securities through trusts for investments in mortgages, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SPECIAL RULES FOR TAXATION OF TRUSTS FOR INVESTMENTS IN MORTGAGES.

(a) IN GENERAL.—Subchapter M of chapter 1 of the Internal Revenue Code of 1954 (relating to taxation of regulated investment companies and real estate investment trusts) is amended by adding at the end thereof the following new part:

"PART IV—TRUSTS FOR INVESTMENTS IN MORTGAGES

"Sec. 860A. TIM's defined.
"Sec. 860B. Taxation of TIM's.
"Sec. 860C. Taxation of shareholders.
"Sec. 860D. Special rules for contributions of property to TIM's.
"Sec. 860E. Qualified obligations.

"SEC. 860A. TIM'S DEFINED.

"(a) IN GENERAL.—For purposes of this title, the term 'TIM' means a corporation, trust, or association—

"(1) which is managed by 1 or more trustees or directors,

"(2) the beneficial ownership of which is evidenced by registered transferable shares, or by transferable certificates of beneficial interest,

"(3) which (but for the provisions of this part) would be taxable as a domestic corporation,

"(4) which is not—

"(A) a financial institution to which section 585, 586, or 593 applies, or

"(B) an insurance company to which subchapter L applies, and

"(5) which meets the requirements of subsections (b), (c), (d), and (e).

"(b) INVESTMENT REQUIREMENTS.—A TIM meets the requirements of this subsection if—

"(1) GROSS INCOME TEST.—At least 95 percent of the TIM's gross income (excluding gross income from prohibited transactions) is derived from—

"(A) qualified obligations, and

"(B) cash, cash items (including receivables), and Government securities.

"(2) GROSS INCOME TEST FROM QUALIFIED OBLIGATIONS.—At least 75 percent of the TIM's gross income (excluding gross income from prohibited transactions) is derived from qualified obligations.

"(3) ASSET TEST.—

"(A) IN GENERAL.—At the close of each quarter of the taxable year, at least 85 percent of the TIM's total assets consist of qualified obligations (other than a commitment to purchase any such obligation), cash and cash items (including receivables), and Government securities.

"(B) CERTAIN FAILURES TO MEET ASSET TEST MAY BE CORRECTED.—Under regulations prescribed by the Secretary, rules similar to the rules of the two sentences following section 856(c)(5) shall apply.

"(4) RESTRICTION ON GROSS INCOME FROM CERTAIN TYPES OF ASSETS.—Not more than 20 percent of the TIM's gross income may be derived from the disposition of—

"(A) stocks or securities held for less than 1 year (other than a qualified short-term investment within the meaning of section 4982(d)), and

"(B) property in a transaction which is a prohibited transaction.

"(c) Active Business Income Not Permitted.—

"(1) In general.—A TIM meets the requirements of this subsection if such trust has no income from the active conduct of a trade or business.

"(2) Treatment of fees and points which are not fees for services.—For purposes of paragraph (1), income received from commitment fees and points in connection with any qualified obligation shall not be treated as income from the active conduct of a trade or business unless such income is for services performed by the TIM.

"(d) Election; Termination of Election.—

"(1) In general.—A TIM meets the requirements of this subsection with respect to any taxable year if—

"(A) within 75 days of the date on which the TIM is incorporated or formed, the TIM elected to have this part apply, and

"(B) such election (or a subsequent election under paragraph (4)) remains in effect through the close of such taxable year.

"(2) FAILURE TO QUALIFY.—An election under paragraph (1) made by a corporation, trust, or association shall terminate if the corporation, trust, or association is not a TIM to which the provisions of this part apply for the taxable year with respect to which the election is made, or for any succeeding taxable year. Such termination shall be effective for the taxable year for which the corporation, trust, or association is not a TIM to which the provisions of this part apply, and for all succeeding taxable years.

"(3) REVOCATION.—An election under paragraph (1) made by a corporation, trust, or association may be revoked by it for any taxable year after the first taxable year for which the election is effective. A revocation under this paragraph shall be effective for the taxable year in which made and for all succeeding taxable years. Such revocation must be made on or before the 90th day after the 1st day of the first taxable year for which the revocation is to be effective. Such revocation shall be made in such manner as the Secretary shall prescribe by regulations.

"(4) ELECTION AFTER TERMINATION OR REVOCATION.—Except as provided in paragraph (5), if a corporation, trust, or association has made an election under paragraph (1) and such election has been terminated or revoked under paragraph (2) or paragraph (3), such corporation, trust, or association (and any successor corporation, trust, or association) shall not be eligible to make an election under paragraph (1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which such termination or revocation is effective.

"(5) EXCEPTION.—If the election of a corporation, trust, or association has been terminated under paragraph (2), paragraph (4) shall not apply if—

"(A) the corporation, trust, or association does not willfully fail to file within the time prescribed by law an income tax return for the taxable year with respect to which the termination of the election under paragraph (1) occurs;

"(B) the inclusion of any incorrect information in the return referred to in subparagraph (A) is not due to fraud with intent to evade tax; and

"(C) the corporation, trust, or association establishes to the satisfaction of the Secretary that its failure to qualify as a TIM to which the provisions of this part apply is due to reasonable cause and not due to willful neglect.

"(e) CLASSES OF STOCK.—

"(1) IN GENERAL.—Except as provided in paragraph (2), a TIM meets the requirements of this subsection only if such trust has only 1 class of stock or other equity interest.

"(2) AUTHORITY FOR MORE THAN 1 CLASS OF EQUITY INTEREST.—A TIM may have more than 1 class of stock or other equity interest if at all times—

"(A) the debt of such TIM is 10 percent or less of the aggregate face amount of the assets of such trust, and

"(B) the par value of such stock or other equity interest equals the aggregate of qualified obligations held by such TIM.

"(f) SPECIAL RULES FOR APPLICATION OF THIS SECTION.—

"(1) CERTAIN TESTS NOT TO APPLY DURING PHASE-IN PERIOD OR FOR COMPLETE LIQUIDATION.—Paragraphs (2) and (4) of subsection (b) shall not apply—

"(A) to any taxable year which includes any portion of the 18-month period beginning on the date on which a TIM is incorporated or formed, or

"(B) under regulations prescribed by the Secretary, during the 6-month period beginning on the date of the adoption of a plan of complete liquidation of such TIM, but only to the extent necessary to carry out such liquidation.

"(2) QUALIFIED OBLIGATIONS HELD AS INVENTORY OR FOR SALE.—Gross income from the sale of any qualified obligation which, in the hands of the trust, is property described in section 1221(1) shall not be taken into account under subsection (b)(2).

"(g) INELIGIBLE TRUSTEES, DIRECTORS, AND SHAREHOLDERS.—The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are ineligible to be trustees, directors, or shareholders of a TIM.

"SEC. 860B. TAXATION OF TIM'S.

"(a) TRUSTS NOT TAXABLE.—A TIM is exempt from taxation under this subtitle.

"(b) ACCOUNTING METHOD.—For purposes of determining taxable income for any taxable year, a TIM shall—

"(1) use the cash method of accounting, and

"(2) have as its accounting period the calendar year.

"SEC. 860C. TAXATION OF SHAREHOLDERS.

"(a) In General.—Except as provided in this part, any shareholder of a TIM shall, for purposes of this title, be treated in the same manner as if—

"(1) the TIM was a partnership, and

"(2) the shareholder was a partner.

"(b) Treatment of Dispositions of Qualified Obligations.—

"(1) Actual distributions.—If the proceeds from the disposition by a TIM of any qualified obligation are distributed to any shareholder, that portion of such distribution which is properly allocable to the principal amount of such obligation shall be treated—

"(A) as if in redemption of the shareholder's shares or certificate, except that—

"(B) the character of the gain from such redemption shall be the same as the character of such gain would have been if such gain had been taxable to the TIM.

"(2) Reinvestment of proceeds.—If the proceeds from the disposition of any qualified obligation by a TIM are used to acquire any other qualified obligation—

"(A) each shareholder shall be treated as having received a distribution of the shareholder's pro rata share of such proceeds (and such distribution shall be treated as an actual distribution), and

"(B) each shareholder shall be treated as having recontributed such amount to the TIM in exchange for shares or certificates having a par value equal to the face amount of the other qualified obligations so acquired.

"(c) SPECIAL RULES FOR 20-PERCENT OR MORE SHAREHOLDERS.—

"(1) IN GENERAL.—In the case of any—

"(A) 20-percent shareholder of a TIM who is a dealer in qualified obligations, or

"(B) financial institution to which section 585, 586, or 593 applies,

any gain from the disposition of any qualified obligation which is allocated to such shareholder shall be treated as ordinary income.

"(2) 20-PERCENT SHAREHOLDER DEFINED.—

"(A) IN GENERAL.—For purposes of this subsection, the term '20-percent shareholder' means any shareholder of a TIM whose equity and debt interest in a TIM at any time equals 20-percent or more of the total equity and debt interests in such TIM at such time.

"(B) RELATED PERSONS' INTERESTS TAKEN INTO ACCOUNT.—In determining the equity and debt interest of any shareholder under subparagraph (A), there shall be taken into account the equity and debt interests of any person related (within the meaning of section 103(b)(6)(C)) to such person.

"(d) SHAREHOLDER DEFINED.—For purposes of this section, the term 'shareholder' means any beneficial owner of a TIM.

"SEC. 860D. SPECIAL RULES FOR CONTRIBUTIONS OF QUALIFIED FIRST OR SECOND MORTGAGES TO TIM'S.

"(a) BASIS OF TIM IN QUALIFIED FIRST OR SECOND MORTGAGES.—A TIM's basis in any qualified first or second mortgage received by the TIM in exchange for an equitable interest in such TIM shall be the fair market value of such mortgage at the time of the transfer.

"(b) GAIN OR LOSS RECOGNIZED BY SHAREHOLDERS.—

"(1) IN GENERAL.—In the case of an exchange described in subsection (a), gain or loss shall be recognized by the person transferring any qualified mortgage to the TIM to the extent such person's basis in such mortgage is greater (or less) than the fair market value of such mortgage.

"(2) TIME FOR RECOGNITION.—Any gain or loss described in paragraph (1) shall be recognized ratably over the remaining term of the qualified first or second mortgage.

"(3) ORDINARY LOSSES.—If any loss recognized by any person under this subsection is treated as an ordinary loss, any gain from the sale or exchange of such person's equity interest in such TIM shall be treated as ordinary income to the extent of such loss.

"SEC. 860E. QUALIFIED OBLIGATIONS.

"For purposes of this part—

"(a) IN GENERAL.—The term 'qualified obligation' means any—

"(1) qualified first or second mortgage,

"(2) qualified participation,

"(3) cash-flow, mortgage-backed bond which is secured by any qualified first and second mortgage,

"(4) equity interest in a TIM,

"(5) qualified repurchase obligation, or

"(6) qualified income investment.

"(b) QUALIFIED FIRST OR SECOND MORTGAGES.—

"(1) IN GENERAL.—The term 'qualified first or second mortgage' means a first or second mortgage (whether or not insured) which—

"(A) is secured by a single-family residence which is (or can reasonably be expected to become) the principal residence of the mortgagor, and

"(B) is used (or can reasonably be expected to be used) to acquire, or to make a home and improvement in connection with, such residence.

"(2) SINGLE-FAMILY RESIDENCE; COOPERATIVES.—Under regulations prescribed by the Secretary, rules similar to the rules of paragraphs (9) and (10) of section 103A(l) shall apply.

"(3) MORTGAGE MAY NOT EXCEED VALUE OF RESIDENCE.—The principal amount of any qualified first or second mortgage on any residence, when added to the aggregate outstanding principal amount of all previous such mortgages on such residence, shall not, on the date such mortgage is issued, exceed the fair market value of such residence on such date.

"(4) CONSTRUCTION LOANS NOT PERMITTED.—The term 'qualified first or second mortgage' shall not include any construction loan.

"(5) ORIGINAL ISSUE DISCOUNT.—Except to the extent provided in regulations prescribed by the Secretary, the term 'qualified first or second mortgage' does not include any mortgage originated with an original issue discount.

"(c) QUALIFIED PARTICIPATION.—The term 'qualified participation' means any participation in any mortgage or pool of mortgages but only if—

"(1) such mortgages would be qualified first or second mortgages if held directly by the TIM, and

"(2) the mortgagees of such mortgages remain the primary obligors.

"(d) QUALIFIED REPURCHASE OBLIGATIONS.—The term 'qualified repurchase obligation' means any qualified first or second mortgage which is subject to a repurchase agreement under which—

"(1) any amount payable to the TIM does not exceed the payments due on the mortgage subject to the agreement,

"(2) such TIM purchases such mortgage for not more than the fair market value of such mortgage, and

"(3) the amount paid for repurchase is fixed at the time the agreement is entered into.

"(e) QUALIFIED INCOME INVESTMENTS.—

"(1) IN GENERAL.—The term 'qualified income investment' means any security, letter of credit, certificate of deposit, surety bond, or other similar instrument or device which—

"(A) is acquired during the 18-month period beginning on the date the TIM is incorporated or formed, and

"(B) is acquired—

"(i) to provide cash to meet fixed obligations of such TIM which cannot be met from investments in other qualified obligations, or

"(ii) to provide income to the TIM to offset income which is lost by reason of the prepayment or liquidation (other than by sale by such TIM) of any qualified obligation before maturity.

"(2) TERMINATION AS QUALIFIED OBLIGATION.—Any qualified income investment shall not be treated as a qualified obligation after the earlier of—

"(A) the date which is 7 years after a TIM is incorporated or formed, or

"(B) in the case of such a TIM with a fixed term, the date on which the first one-third of such term has expired.".

(b) CONFORMING AMENDMENT.—The table of parts for subchapter M of chapter 1 of such Code is amended by adding at the end thereof the following new part:

"Part IV. Trusts for investments in mortgages.".

SEC. 2. TAX ON PROHIBITED TRANSACTIONS OF TIM'S.

(a) Imposition of Tax.—Chapter 44 of the Internal Revenue Code of 1954 (relating to excise tax on real estate investment trusts) is amended by adding at the end thereof the following new section:

"SEC. 4982. EXCISE TAX ON PROHIBITED TRANSACTIONS OF TIM'S.

"(a) Imposition of Tax.—There is hereby imposed on each prohibited transaction of a TIM a tax in an amount equal to the gain or loss allocable to such transaction.

"(b) Prohibited Transaction Defined.—For purposes of this section, the term 'prohibited transaction' means the disposition by a TIM of—

"(1) any qualified obligation held by such TIM for less than 3 years, or

"(2) any qualified obligation which is—

"(A) held by the TIM for 3 years or more, and

"(B) described in section 1221(l).

"(c) Exception From Prohibited Transactions.—

"(1) In general.—A disposition shall not be treated as a prohibited transaction if—

"(A) such disposition is in connection with the prepayment, retirement, or renegotiation of a qualified obligation, "(B) such disposition is of—

"(i) any defective qualified obligation,

"(ii) foreclosure property, or

"(iii) qualified short-term investment, or

"(C) such disposition is in connection with the involuntary liquidation or dissolution of a TIM.

"(2) CERTAIN TRANSACTIONS NOT TREATED AS PROHIBITED TRANSACTIONS.—Paragraph (2) of subsection (b) shall not apply to any qualified obligation described in such paragraph for any taxable year if—

"(A) not more than 20 percent of the aggregate face amount of all such qualified obligations are disposed of during such taxable year,

"(B) not more than 50 percent of the aggregate face amount of all such qualified obligations are disposed of during taxable year, but not more than 5 obligations are disposed of during such taxable year, or

"(C) the disposition is—

"(i) pursuant to a bulk sale as part of a plan of complete liquidation, and

"(ii) by a TIM which has been a TIM for at least 3 taxable years before such disposition.

"(d) QUALIFIED SHORT-TERM INVESTMENTS.—

"(1) IN GENERAL.—For purposes of this section, the term 'qualified short-term investment' means any qualified obligation which—

"(A) is designated by a TIM as a qualified short-term investment on the date such obligation is acquired,

"(B) is held by a TIM for less than 180 days (or if longer than 180 days, is held to maturity), and

"(C) the proceeds of which are—

"(i) used to acquire other qualified obligations, or

"(ii) distributed by the TIM to its shareholders.

"(2) SPECIAL RULE FOR REINVESTMENT DURING PHASE-IN PERIOD.—Notwithstanding paragraph (1), during the 18-month period beginning on the date a TIM is incorporated or formed, proceeds from the disposition of a qualified short-term investment may be invested in other qualified short-term investments.

"(e) DEFINITIONS.—For purposes of this section—

"(1) TIM; QUALIFIED OBLIGATIONS.—The terms 'TIM' and 'qualified obligation' have the same meanings as when used in part IV of subchapter M of chapter 1.

"(2) FORECLOSURE PROPERTY.—The term 'foreclosure property' has the same meaning given such term by section 856(e) without regard to whether such property is held by a real estate investment trust.".

(b) CONFORMING AMENDMENTS.—The table of sections for chapter 44 of the Internal Revenue Code of 1954 is amended—

(1) by inserting "AND TIM'S" after "TRUSTS" in the heading thereof, and

(2) by adding at the end thereof the following new item:

"Sec. 4982. Excise tax on prohibited transactions of TIM's.".

II

Calendar No. 522

98TH CONGRESS
1ST SESSION

S. 2040

[Report No. 98–293]

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the treatment of mortgage backed securities, to increase the authority of the Federal Home Loan Mortgage Corporation, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 2 (legislative day, OCTOBER 31), 1983

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, reported the following bill; which was read twice and placed on the calendar

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A BILL

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the treatment of mortgage backed securities, to increase the authority of the Federal Home Loan Mortgage Corporation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Secondary Mortgage Market Enhancement Act of 1983".

TITLE I—SECURITIES LAWS AMENDMENTS

REGISTRATION EXEMPTION

SEC. 101. Section 4(5) of the Securities Act of 1933 is amended to read as follows:

"(5) Transactions involving one or more promissory notes, participation interests in such notes, or mortgage related payment securities secured by such notes or participation interests, offered and sold subject to the following conditions:

"(A) The note or notes are directly secured by a first lien or a second lien on—

"(i) a single parcel of real estate (including stock allocated to a dwelling unit in a residential cooperative housing corporation) upon which is located a dwelling or other residential or commercial structure, or

"(ii) a manufactured home, as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974, which is used as a residence;

"(B) The note or notes were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority or were originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 203 and 211 of the National Housing Act; and

"(C) The terms of the sale require that—

"(i) the minimum aggregate sales price to the purchaser be not less than $250,000,

"(ii) payment of the sales price by the purchaser be made with cash within one hundred twenty days of the date of sale, and

"(iii) each purchaser buy only for his own account.

For the purpose of this paragraph, the term 'mortgage related payment securities' means (I) any obligation (which may be with or without recourse to the issuer thereof) which, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the requirements of subparagraphs (A) and (B) or participations in such notes which are pledged as security for such obligation, and (II) any participation interest in a pool or pools of such notes and the proceeds thereof, and any related rights designed to assure servicing of, or the receipt or timeliness of receipt by holders of such mortgage related payment securities of amounts payable under, such mortgage notes if such obligation or participation interest is rated in one of the four highest rating categories by at least one nationally recognized rating organization.".

INVESTMENT BY DEPOSITORY INSTITUTIONS

SEC. 102. (a) Section 5(c)(1) of the Home Owner's Loan Act of 1933 (12 U.S.C. 1464(c)(1)) is amended by adding at the end thereof the following:

"(S) MORTGAGE BACKED SECURITIES.—Investments in securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered and sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section, subject to such regulations as the Board may prescribe.".

(b) Section 107 of the Federal Credit Union Act (12 U.S.C. 1757) is amended—

(1) by redesignating paragraph (15) as paragraph (16); and

(2) by inserting after paragraph (14) the following:

"(15) to invest in securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered or sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section, subject to such regulations as the Board may prescribe.".

(c) Section 5136 of the Revised Statutes (12 U.S.C. 24) is amended by adding at the end of paragraph Seventh the following: "The limitations and restrictions contained in this paragraph as to an association purchasing for its own account investment securities shall not apply to securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered and sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section, subject to such limitations as the Comptroller of the Currency may prescribe.".

PREEMPTION OF STATE LAW

SEC. 103. (a) Any person, trust, corporation, partnership, association, business trust, or business entity created pursuant to or existing under the laws of the United States or any State shall be authorized to purchase, hold, and invest in securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered and sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section if such securities are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization, and in securities issued or guaranteed by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association, to the same extent that such person, trust, corporation, partnership, association, business trust, or business entity is authorized under any applicable law to purchase, hold or invest in obligations issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. Where State law limits the purchase, holding, or investment in obligations issued by the United States by such a person, trust, corporation, partnership, association, business trust, or business entity, such securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered and sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section if such securities are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization, or such Federal Home Loan Mortgage Corporation or Federal National Mortgage Association securities shall be considered to be obligations issued by the United States for purposes of the limitation.

(b) The provisions of subsection (a) shall not apply with respect to a particular person, trust, corporation, partnership, association, business trust, or business entity or class thereof in any State which, prior to the expiration of three years after the date of enactment of this Act, enacts a statute which specifically refers to this section and either prohibits or provides for a more limited authority to purchase, hold, or invest in such securities by any person, trust, corporation, partnership, association, business trust, or business entity or class thereof than is provided in subsection (a). The enactment by any State of any statute of the type described in the preceding sentence shall not affect the validity of any contractual commitment to purchase, hold, or invest which was made prior thereto and shall not require the sale or other disposition of any securities acquired prior thereto.

(c) Any securities which are offered and sold pursuant to section 4(5) of the Securities Act of 1933 or which would be eligible to be offered and sold pursuant to section 4(5) of the Securities Act of 1933 except for the requirement of subparagraph (C)(i) of such section if such securities are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization, shall be exempt from any law of any State with respect to or requiring registration or qualification of securities or real estate to the same extent as any obligation issued by or guaranteed as to principal and interest by the United States or any agency or instrumentality thereof. Any State may, prior to the expiration of three years after the date of enactment of this Act, enact a statute which specifically refers to this section and requires registration or qualification of any such security on terms which differ from those applicable to any obligation issued by the United States.

DELAYED OR CONTINUOUS REGISTRATION

SEC. 104. The Securities and Exchange Commission shall, by rule or regulation, provide for the registration pursuant to section 6 of the Securities Act of 1933 of one or more promissory notes, participation interests in such notes, or mortgage related payment securities secured by such notes or participation interests, which are to be offered and sold on a delayed or continuous basis in the future, where the notes or participation interests therein are directly secured by a first lien or a second lien on (1) a single parcel of real estate (including stock allocated to a dwelling unit in a residential cooperative housing corporation) upon which is located a dwelling or other residential or commercial structure, or (2) a manufactured home, as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974, which is used as a residence.

TITLE II—FEDERAL HOME LOAN MORTGAGE CORPORATION AND FEDERAL NATIONAL MORTGAGE ASSOCIATION AMENDMENTS

FEDERAL HOME LOAN MORTGAGE CORPORATION

PREFERRED STOCK

SEC. 201. Section 306(f) of the Federal Home Loan Mortgage Corporation Act is amended—

(1) by inserting before the period at the end of the last sentence thereof the following: ", and shall not be entitled to vote with respect to the election of any member of the Board of Directors"; and

(2) by adding at the end thereof the following: "Such preferred stock, or any class thereof, may have such terms as would be required for listing of preferred stock on the New York Stock Exchange, except that this sentence does not apply to any preferred stock, or class thereof, the initial sale of which is made directly or indirectly by the Corporation exclusively to any Federal Home Loan Bank or Banks.".

FEDERAL NATIONAL MORTGAGE ASSOCIATION PREFERRED STOCK

SEC. 202. (a) The first sentence of section 303(a) of the National Housing Act is amended to read as follows: "The corporation shall have common stock, without par value, which shall be vested with voting rights, each share being entitled to one vote with rights of cumulative voting at all elections of directors.".

(b) Section 303 of such Act is amended by adding at the end thereof the following:

"(h) Any preferred stock of the corporation may have such rights as are permitted by the rules of the New York

Stock Exchange in the case of securities listed on such Exchange.".

(c) Section 308(b) of such Act is amended by striking out the word "common" in the first sentence.

LIMITATIONS ON PARTICIPATION AGREEMENTS BY FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION

SEC. 203. (a) The sixth sentence of section 302(b)(2) of the National Housing Act is amended to read as follows: "The corporation shall establish limitations governing the maximum principal obligation of conventional mortgages that are purchased by it; in any case in which the corporation purchases a participation interest in such a mortgage, the limitation shall be calculated with respect to the total principal obligation of the mortgage and not merely with respect to the interest purchased by the corporation.".

(b) The fifth sentence of section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act is amended to read as follows: "The Corporation shall establish limitations governing the maximum principal obligation of conventional mortgages that are purchased by it; in any case in which the Corporation purchases a participation interest in such a mortgage, the limitation shall be calculated with respect to the total principal obligation of the mortgage and not merely with respect to the interest purchased by the Corporation.".

FEDERAL HOME LOAN MORTGAGE CORPORATION MANUFACTURED HOUSING LOANS

SEC. 204. (a) Section 302(d) of the Federal Home Loan Mortgage Corporation Act is amended by inserting after "located," the following: "or a manufactured home which is personal property under the laws of the State in which the manufactured home is located,".

(b) Section 302(h) of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof the following: "The term 'residential mortgage' also includes a loan or advance of credit secured by a mortgage or other lien on a manufactured home which is the principal residence of the borrower, without regard to whether the security property is real, personal, or mixed.".

(c) Section 305(a)(1) of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof the following: "Where a residential mortgage is secured by a manufactured home, the term 'mortgage insurance program' shall also include any manufactured home lending program under section 2 of the National Housing Act.".

FEDERAL HOME LOAN MORTGAGE CORPORATION AUTHORITY TO PURCHASE STATE AGENCY INSURED MORTGAGES

SEC. 205. Section 302(i) of the Federal Home Loan Mortgage Corporation Act is amended by striking out "a

State or an agency or instrumentality of either" and inserting in lieu thereof "any of its agencies or instrumentalities".

FEDERAL HOME LOAN MORTGAGE CORPORATION GUARANTEE OF MORTGAGE-BACKED SECURITIES ISSUED BY OTHERS

SEC. 206. Section 306 of the Federal Home Loan Mortgage Corporation Act is amended by adding at the end thereof of the following:

"(h) The Corporation may not guarantee mortgage-backed securites or mortgage related payment securities backed by mortgages not purchased by the Corporation.".

FORTY-FIVE-DAY APPROVAL PERIOD

SEC. 207. Section 309 of the National Housing Act is amended by adding at the end thereof the following new subsection:

"(i) If the Federal National Mortgage Association submits to the Secretary of Housing and Urban Development, after the date of the enactment of the Secondary Mortgage Market Enhancement Act of 1983, a request for approval or other action under this title, the Secretary shall, not later than the expiration of the forty-five-day period following the submission of such request, approve such request or transmit to the Congress a report explaining why such request has not been approved. Such period may be extended for an additional fifteen-day period if the Secretary requests additional information from the corporation. If the Secretary fails to transmit such report to the Congress within such forty-five-day or sixty-day period, as the case may be, the corporation may proceed as if such request had been approved.".

MULTIFAMILY MORTGAGE LOAN-TO-VALUE RATIO

SEC. 208. (a) The second sentence of section 302(b)(2) of the National Housing Act is amended by inserting after "mortgage" the first place it appears the following: "secured by a property comprising one- to four-family dwelling units".

(b) The first sentence of section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act is amended by inserting after "mortgage" the first place it appears the following: "secured by a property comprising one- to four-family dwelling units".

BOARD OF DIRECTORS

SEC. 209. The first sentence of section 308(b) of the National Housing Act is amended to read as follows: "The Federal National Mortgage Association shall have a board of directors, which shall consist of eighteen persons, five of whom shall be appointed annually by the President of the United States, and the remainder of whom shall be elected annually by the stockholders.".

HOUSING AND URBAN DEVELOPMENT ANNUAL REPORT TO THE CONGRESS ON FEDERAL NATIONAL MORTGAGE ASSOCIATION ACTIVITY

SEC. 210. Section 309(h) of the National Housing Act is amended by striking out the last two sentences and inserting in lieu thereof the following: "Pursuant to the authority provided in this subsection, the Secretary shall, not later than June 30 of each year, report to the Congress on the activities of the corporation under this title.".

MULTIFAMILY LIMITS

SEC. 211. (a) The penultimate sentence of section 302(b)(2) of the National Housing Act is amended by inserting before the period at the end thereof the following: ", except that such limitations may be increased to not to exceed 240 per centum of the dollar amount limitations contained in section 207(c)(3) of the National Housing Act in any geographical area for which the Secretary determines under section 207(c)(3) that cost levels require any increase in dollar amount limitations under that section".

(b) The penultimate sentence of section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act is amended by inserting before the period at the end thereof the following: ", except that such limitations may be increased to not to exceed 240 per centum of the dollar amount limitations contained in section 207(c)(3) of the National Housing Act in any geographical area for which the Secretary of Housing and Urban Development determines under section 207(c)(3) that cost levels require any increase in dollar amount limitations under that section".

PURCHASE OF SECOND MORTGAGES BY FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION

SEC. 212. (a) Section 302(b) of the National Housing Act is amended by adding the following new paragraph at the end thereof:

"(5)(A) The corporation is authorized to purchase, service, sell, lend on the security of, and otherwise deal in conventional mortgages or advances of credit that are secured by a subordinate lien against a one- to four-family residence only if (i) the residence is the principal residence of the mortgagor, (ii) the proceeds of such loan were used to purchase or to refinance only the remaining balance of a loan the proceeds of which were used to purchase the residence, and (iii) the commitment to purchase the loan is issued prior to October 1, 1985, except as provided by paragraph (3). If the corporation, pursuant to paragraphs (1) through (4), shall have purchased, serviced, sold, or otherwise dealt with any other outstanding mortgage secured by the same residence, the aggregate original amount of such other mortgage and the mortgage authorized to be purchased, serviced, sold, or otherwise dealt with under this paragraph shall not exceed the applicable limitation set forth in paragraph (2).

"(B) The corporation shall establish limitations governing the maximum principal obligation of subordinate conventional mortgages described in subparagraph (A). Such limitations shall not exceed $50,000 in the case of a one-family residence and $60,000 in the case of a two- to four-family residence. In any case in which the corporation purchases a participation interest in such a mortgage, the limitation shall be calculated with respect to the total principal obligation of the mortgage and not merely with respect to the interest purchased by the corporation.

"(C) No subordinate mortgage shall be purchased by the corporation if the total outstanding indebtedness secured by the property as a result of such mortgage exceeds 80 per centum of the value of such property unless (i) that portion of such total outstanding indebtedness that exceeds such 80 per centum is guaranteed or insured by a qualified insurer as determined by the corporation (and not the corporation itself); (ii) the seller retains a participation of not less than 10 per centum in the mortgage; or (iii) for such period and under such circumstances as the corporation may require, the seller agrees to repurchase or replace the mortgage upon demand of the corporation in the event that the mortgage is in default. The corporation shall not issue a commitment to purchase a subordinate mortgage prior to the date the mortgage is originated, if such mortgage is eligible for purchase under the preceding sentence only by reason of compliance with the requirements of clause (ii) of such sentence.".

(b)(1) Section 302(h) of the Federal Home Loan Mortgage Corporation Act is amended—

(A) by striking out "The maximum principal obligation" and all that follows through "associations."; and

(B) by adding at the end thereof the following: "Until October 1, 1985, the term 'residential mortgage' shall also include purchase or refinancing loans or advances of credit that are secured by a subordinate lien against a one- to four-family residence only if the residence is the principal residence of the borrower and the proceeds of such loan or advance of credit were used to purchase or to refinance only the remaining balance of a loan the proceeds of which were used to purchase such residence.".

(2) Section 305(a) of such Act is amended by adding the following new paragraph at the end thereof:

"(4)(A) With respect to the purchase by the Corporation of any purchase or refinancing residential mortgage secured by a subordinate lien against a one- to four-family residence as authorized by the last sentence of section 302(h), the Corporation shall establish limitations governing the maximum principal obligation of such mortgages. Such limitation shall not exceed $50,000 in the case of a one-family residence and $60,000 in the case of a two- to four-family residence. In any case in which the Corporation purchases a participation interest in such a mortgage, the limitation shall be calculated with respect to the total principal obligation of the mortgage and not merely with respect to the interest purchased by the Corporation. If the Corporation shall have purchased, serviced, sold, or otherwise dealt with any other outstanding mortgage secured by the same residence, the aggregate original amount of such other mortgage and the mortgage authorized to be purchased, serviced, sold, or otherwise dealt with under this paragraph shall not exceed the applicable limitation set forth in paragraph (2).

"(B) No subordinate mortgage shall be purchased by the Corporation if the total outstanding indebtedness secured by the property as a result of such mortgage exceeds 80 per centum of the value of such property unless (i) that portion of such total outstanding indebtedness that exceeds 80 per centum is guaranteed or insured by a qualified insurer as determined by the Corporation (and not the Corporation itself); (ii) the seller retains a participation of not less than 10 per centum in the mortgage; or (iii) for such period and under such circumstances as the Corporation may require, the seller agrees to repurchase or replace the mortgage upon demand of the Corporation in the event that the mortgage is in default. The Corporation shall not issue a commitment to purchase a subordinate mortgage prior to the date the mortgage is originated, if such mortgage is eligible for purchase under the preceding sentence only by reason of compliance with requirements of clause (ii) of such sentence.".

(c) The amendments made by this section do not apply to commitments issued prior to the date of enactment of this section.

Senator TOWER. Our first witnesses this morning are Mr. David Beal, president of Norwest Mortgage, Inc. and Residential Funding Corp. of Minneapolis; Mr. Charles Reed, president, Sears Mortgage Securities Corp., San Francisco; and Mr. Claude E. Pope, chairman of the board and chief executive officer, General Electric Mortgage Insurance Corp. of Raleigh, N.C.

Let me say at the outset, gentlemen, as much as I dislike to do this, I'm going to have to limit each oral presentation to 5 minutes because we do have a number of witnesses to hear from this morning and, as a matter of fact, something on the order of 10 witnesses. Therefore, you may submit as much written or printed material as you would like and we will include all of that in the record. We will include the complete statements in the record if you can summarize those presentations. Again, I'm loath to say this, but we're going to have strict enforcement of the time limit on the presentations so that my colleagues will have some time for questions.

So let me first call on Mr. Beal. Incidentally, on each panel we will hear from all the witnesses first before we proceed to question.

STATEMENT OF DAVID BEAL, PRESIDENT, NORWEST MORTGAGE, INC. AND RESIDENTIAL FUNDING CORP., MINNEAPOLIS, MINN.

Mr. BEAL. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF

DAVID BEAL

President
NORWEST MORTGAGE, INC.
AND
RESIDENTIAL FUNDING CORPORATION

Norwest Mortgage Company

Mr. Chairman, my name is David Beal. I am the President of Norwest Mortgage, Inc. and a member of the Board of Directors of its subsidiary Residential Funding Corporation. Both firms are headquartered in Minneapolis, Minnesota. Norwest Mortgage originates, markets and services residential and commercial first mortgage loans. It is the third largest mortgage banking firm in the country--servicing over $10 billion in loans. Residential Funding purchases mortgage loans from other institutions and resells these loans in the secondary market.

I appreciate the opportunity to appear this morning and to express our support for S. 1821, the Secondary Mortgage Market Enhancement Act. S. 1821, along with S. 1822 (the Trust for Investment in Mortgages or "TIMS" proposal), represent major new initiatives to broaden and encourage involvement by the private sector in the development of the secondary mortgage market. We commend both Senator Tower and Senator Garn for their understanding of the importance of the private secondary market in meeting the nation's housing needs. We also commend the staff for their professionalism and understanding in dealing with these issues.

Mr. Chairman, we at Norwest Mortgage have a strong commitment to the continued development of the private secondary mortgage market. A year ago, we saw an opportunity to enter the secondary market for non-conforming mortgages, those mortgages larger in amount than $108,300, and to establish our company as one of the leading providers of capital to the housing industry. Nine months ago, we established a subsidiary, Residential Funding Corporation, to be a new private participant in the secondary mortgage market employing a conduit system of loan purchasing and pooling of mortgage-backed securities. Combining our efforts and those of Mortgage Guaranty Insurance Corporation "MGIC" and Salomon Brothers, we have to date attracted 1,600 lender applicants, nationwide. By the end of Residential Funding's first year of operation, we will have purchased on an annualized volume basis $4 billion of residential mortgages, thus providing a significant new source of capital to the housing industry. Those served are largely well-to-do home buyers who have mortgage needs that exceed those of low and moderate income Americans. Our experience has demonstrated to us that we, along with the other private companies now in the market and those that will follow, can continue our growth and can adequately service this market sector, provided that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not allowed to deviate from their historic mission of providing housing funds for low and moderate income Americans. It is likely that, if allowed to enter new segments of the secondary mortgage market, the advantages enjoyed by these agencies in the capital markets by virtue of their perception as quasi-governmental agencies would permit them to dominate those segments as well.

We are truly excited about the future of the housing industry. We are on the threshhold of developing innovative techniques for raising substantial amounts of capital from the private capital markets, innovative techniques which we believe will continue to evolve to the benefit of all participants in the residential housing sector of our economy. The market participants will continue the development of new products, services and delivery systems, all of which, we believe, will accrue to the benefit of the homebuyer by reducing his costs.

During this year, in addition to establishing Residential Funding, we solved and removed several impediments to structuring a conduit program such as ours. First, a segment of the housing market which has been denied access to the private secondary market is comprised of units in high-rise condominiums. This results from the perceived increase in risk if a pool of mortgages contains too many of the units in a single condominium building. We have been instrumental in assisting the industry to define new risk standards which will enable us to serve this market and to be an active purchaser of mortgages in high-rise condominiums in every state.

As the members of this committee are well aware, the State of California has posed special problems for the non-government participants such as ourselves because of the inherent danger of earthquakes. Our mortgage insurance providers have solved this problem and we are now able to expand our commitment to serve all borrowers and lenders in California and the other states in which this problem existed.

As we have become active in the secondary market, we have identified another type of housing that needs an active secondary market outlet--that is, manufactured housing. Manufactured housing now comprises nearly one-third of all new single-family homes sold in the U.S. today. A manufactured home costs about 30% less to build than the traditional site built dwelling. We believe manufactured homes will play an increasingly larger role in the housing market in the future and we intend to be a leader in this field. Accordingly, we have established a separate manufactured housing subsidiary which is now actively working in the Sun Belt area of the country.

Finally, we will be adding more new programs in the near future to those already offered by Residential Funding as part of our goal to serve all sectors of the housing market. Our plans include purchasing seasoned mortgages through whole loan sales as well as a swap program similar to those being carried out by FHLMC and FNMA. We think these programs will be very positively received by the thrift industry as an additional means of achieving greater portfolio liquidity. We are actively developing a new construction and builder bond program to assist the needs of builders of all sizes. This program would provide construction loans and permanent forward commitments for residential housing and provide an aggregating function for a multi-builder bond program. The program should, once fully developed, provide a significant source of funds for builders of all sizes. Innovations such as those that I have just mentioned and continued growth for private sector participants in the secondary market must be encouraged. To that end, we would urge this committee not to expand the powers of the government supported agencies at this time. These agencies already enjoy a dominant position in the capital markets as a result of the federal government's existing support for these programs.

S. 1821

Let me now address S. 1821, the Secondary Mortgage Market Enhancement Act of 1983. As we stated earlier, we favor its enactment. While our securities have been readily accepted by investors and have been traded effectively in the secondary market, the market's receptivity to them would be greatly facilitated with the passage of S. 1821, which would give the private sector some of the parity it seeks with the government supported agencies. We believe the legislation would enhance the attractiveness of the secondary mortgage market for a wide range of present participants and potential new entrants, including all types of financial institutions. The bill would remove many of the existing economic disincentives to participation in this market and may serve to enhance the competitive position of the private sector relative to the FHLMC and FNMA. Obviously, it will take some time to determine whether the provisions of the bill will have any long-term impact on reducing our comparable borrowing costs. From our viewpoint, the bill will not operate to the singular advantage of any particular group or industry segment, but rather should benefit all those in the housing industry.

We support Section 101 of the Bill because of two primary changes to Section 4(5) of the Securities Act of 1933. In addition to first mortgages, Section 101 offers exemptions from the registration requirements for large transactions of securities backed by secondary mortgages, residential manufactured housing mortgages and residential housing cooperative mortgages. Secondly, it expands the allowable security to include mortgage-backed funds.

Sections 102 to 105 would broaden the marketplace for mortgage-backed securities by reducing the cost of holding the securities. Currently, the capital requirements for broker/dealers are lower for governmental obligations than for other types of securities. Section 102 would permit broker/dealers to meet the capital requirements for holding mortgage-backed securities on the same basis as if they held government obligations. Therefore, mortgage-backed securities would become more attractive inventory assets for brokerage houses. Section 103 would allow broker/dealers to extend margin credit for securities exempt from registration by Section 101 on the same basis as they may for government securities. Section 104 would authorize federally chartered depository institutions to invest in mortgage-backed securities, thus expanding the investor base. Section 105 would allow federally insured commercial banks to underwrite and deal in non-governmentally issued mortgage-backed securities subject to restrictions and requirements imposed by the appropriate federal regulatory agency.

Section 106 would enable state regulated institutions to invest in these mortgage related securities to the same extent state law enables them to invest in government obligations. The federal preemption could be overturned by a state by the enactment of a specific statute to the contrary. This provision would enlarge the number of investors able to invest in mortgage-backed securities.

The final section of Title I would require the Securities and Exchange Commission to permit the use of the shelf registration procedure for issuers of mortgage related securities to be extended beyond the current September 1983 expiration date. The shelf procedure provides the mechanism for obtaining prompt clearance for the initial and subsequent offering of securities, allowing the issuer to take advantage of a quickly changing interest rate environment. It is the use of this recently developed expedited registration process that has enabled the private sector to enter the secondary market despite the volatility of interest rates.

I would anticipate that, taken together, these new provisions will have the effect of attracting significant new amounts of capital to the secondary market and will provide private participants with an increased ability to compete with the government supported agencies, but will not enable us to compete as equals with them. We believe their quasi-agency status will enable them to continue to borrow at rates below our borrowing costs.

Title II of the Bill provides amendments to the charter acts of FHLMC and FNMA. We do not object to any of those provisions.

We have heard numerous alternative suggestions for revamping and updating FNMA and FHLMC. We will mention the most widely discussed possibilities and our initial reaction to them and offer some suggestions as to how Congress may most effectively deal with these housing agencies, which we believe have served a valid and useful public policy purpose. First, the concept of forming a holding company and separate subsidiary for the purpose of financing non-conforming loans would have no real effect unless all ties to the government were severed. All borrowings, security issues, staff and directors, capital infusions, etc., would need to be divorced entirely from FNMA and FHLMC for such a subsidiary to be a truly private entity. The next thought that occurs, of course, is why would all this be necessary? If it would, in fact, be a private subsidiary, then why not let the existing private companies in this business do what this company would be chartered to do.

Second, it is difficult to see--in light of FNMA's substantial portfolio of "underwater" loans--how FNMA could sever its ties with the government or go private. The likely results of such a transaction are twofold. First, FNMA's existing stockholders would be left holding stock of an essentially insolvent company. Second, FNMA's balance sheet weakness would severely limit its ability to borrow and, therefore, drastically reduce the scope of its operations.

Third, forcing FNMA to liquidate its portfolio and in effect begin again with the hopes of operating as a profitable private company would result in a loss to the government of approximately $7-8 billion when the portfolio was sold. This, obviously, is not a proposal that would elicit widespread support, though it does bring to light the dire circumstances of FNMA's present financial position. To continue to allow FNMA's portfolio to expand without limitation risks imposing an ever-increasing burden on the federal government. Thus, Congress initially perhaps should consider limiting either the amount of debt issued by FNMA or the size of its portfolio and perhaps require a phased reduction of the portfolio. The size of this deficit also mandates against enlarging the scope of FNMA's operations by increasing the statutory loan limits.

Fourth, the privatization of FHLMC deserve consideration given its inherent financial strength. It would be a fair competitor to the private sector. However, privatization must be accompanied by a severing of all ties between FHLMC and the federal government, so as not to unfairly disadvantage its private competitors.

Fifth, leaving FNMA and FHLMC in their current status without any increases in authority or merging them while reducing their agency status would be acceptable if the goal was total private status in a relatively short period of time.

Sixth, to transfer $50 billion of FNMA's lowest interest rate loans along with $50 billion of its lowest interest rate outstanding debt to GNMA and to privatize the remainder of FNMA's assets and liabilities. It should then be made a requirement that all future purchases of loans be properly matched with sales of FNMA's securities, rather than permitting FNMA to engage in interest rate speculation by holding uncovered loans.

Finally, perhaps it would be prudent and timely to establish a commission for the sole purpose of determining whether FNMA and FHLMC should be merged, privatized or altered so as to better serve the low and moderate income sector.

The Future

Let me briefly address several other issues under the general subject of the future of the secondary mortgage market.

We would encourage the consideration of legislation to provide a new investment vehicle for mortgage-backed securities known as "TIMS". Enacting legislation containing the TIMS concept would aid the private sector's issuance of mortgage-backed securities enormously, and would lift the trading restraints that have resulted from the grantor-trust structure under which our securities currently are issued.

TIMS legislation, with its active management and call protection features, tax and ERISA considerations, and accompanying changes in the securities laws would greatly enhance our access to the capital markets and thereby decrease the government's need to expand its role in the housing industry.

We support the concept TIMS and will be prepared to testify on the issue upon the invitation of this or any other committee.

Mr. Chairman, with the continued development of the private secondary market, the future for housing finance looks to me to be unlimited except by demand. All participants in the housing industry will benefit from the new ideas in the bills before us. These proposals will encourage and enhance the ability of the private sector to play an ever increasing role in providing capital to the housing industry, and at the same time ensure that strong government support remains directed at housing low to moderate income families and individuals--the most needy sector of the market.

Mr. Chairman, in closing my remarks, let me emphasize that companies in addition to our own have made substantial investments in the future of the private secondary mortgage market. For a market that is only two years old and which has been totally dominated by federal agencies, this is in itself impressive. The potential rewards for homeowners in this country are great, provided that private participants are not discouraged from proceeding with their plans and efforts. I believe that private participation in the secondary mortgage market, if allowed to continue, will provide lower mortgage rates for all homebuyers due to the innovations and the competitive pressures it will bring to bear. These benefits will not be realized, however, if this committee accepts, under any circumstances, any increase in the mortgage ceiling for the government agencies because to do so would severely, perhaps fatally, impair this young, but innovative and developing, market sector.

Because the private secondary market for mortgages is so new, no one can really predict how large this market will become, what its needs will be and how enthusiastically and quickly the thrifts and other loan originators will begin to use it. Looking at thrift behavior since the passage of the Garn-St Germain Act expanded their powers suggests that it will take quite some time for that industry to adjust to their new powers and to make broad changes to the way they manage their loan portfolios. I would like to suggest that all participants in this newly-developing secondary mortgage market be asked to return to this committee next year to assess for you what the market demands and potential are. Another year will give us a much greater experience on which to base our assessments and will give us time to see what I believe will be the very positive impact should the provisions of S. 1821 be enacted.

Mr. Chairman, that concludes my written statement. I am prepared to answer the subcommittee's questions.

Senator TOWER. Thank you, Mr. Beal.

Mr. Reed.

STATEMENT OF CHARLES REED, PRESIDENT, SEARS MORTGAGE SECURITIES CORP., SAN FRANCISCO, CALIF.

Mr. REED. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF CHARLES E. REED

Mr. Chairman and members of this distinguished Subcommittee:

My name is Charles E. Reed and I am President of Sears Mortgage Securities Corporation. Today, I will be presenting the following remarks on behalf of Sears, Roebuck and Co.

I appreciate the opportunity to appear before this Subcommittee today and will comment primarily on S. 1821, The Secondary Mortgage Market Enhancement Act of 1983.

Before commenting on specific sections of this bill, I would like to emphasize that there exists today a critical need for Congress to support the development of the private secondary mortgage market. This can be accomplished by permitting the private sector to expand, thereby providing the additional capital needed to fund current and projected housing finance needs.

Sears Participation

Sears is committed to the development of the private secondary mortgage market sector. In a short time, Sears will enter the secondary mortgage pass-through market through Sears Mortgage Securities Corporation ("Sears Mortgage"), which will function as a buyer of residential mortgage loans and as an issuer of mortgage-backed securities. Sears Mortgage will function in much the same fashion entities who are currently serving the market - such as Norwest Mortgage, General

Electric Mortgage Securities Corporation, Prudential-Bache - and other private entities who will later enter the market.

Sears concurs with the statements made by Senator Tower in the introduction of S. 1821. The private sector must be able to fully compete with Federal mortgage agencies and must also be able to fund an increasing portion of the demand for mortgage credit in the secondary market. S. 1821 is a significant step in that direction. Sears supports S. 1821 and offers the following comments and observations.

THE MORTGAGE CREDIT GAP AND GROWTH OF THE PRIVATE SECTOR

There is no question that the ever-increasing demand for mortgage credit cannot be provided solely by historical funding sources. Previous comments by FNMA and FHLMC, as summarized by Senator Tower in his introductory statement to S. 1821, support this conclusion. The private sector must be available to bridge this gap. To do so, privately issued mortgage-related securities should be placed in a trading position on par with similar corporate securities and closer to agency issued securities. In addition, the investor market must be broadened from the purely institutional investor to individual investors as well. Sears believes that S. 1821 represents a significant step in achieving these goals.

We must point out, however, that there remain several potential impediments to the rapid development of the private sector mortgage-related securities market.

First, the development of a fully operational private issuer or "conduit" activity is an undertaking which cannot be accomplished overnight. PMI Mortgage Corporation, the predecessor to Sears Mortgage Securities Corporation, became operational in August of 1979 - after more than a year's effort and nearly $1 million in start-up costs. The company's first pass-through offering in 1979, was the first private sector public offering of pass-through securities backed by a multi-state pool of mortgage loans from lenders across the country. At that time, Sears, through PMI Mortgage Corporation, made a significant commitment to help create a secondary market in privately issued mortgage related securities.

To date, Sears Mortgage Securities Corp. (through PMI Mortgage Corporation) has committed to issue or has issued in excess of $400 million of mortgage pass through securities, and acts as administrator and master servicer on an additional $400 million in securities issued by others.

Other private secondary market entities, including RFC/Norwest, General Electric Mortgage Securities Corporation and Prudential/Bache are investing capital and creating mortgage-backed securities to provide funds for the housing market. However, it will take time for these private companies to issue mortgage related securities in a volume sufficient to develop an active and consistent secondary market.

Second, the dominance of the secondary market in mortgage-backed securities by Federal agencies has made it difficult for private sector entities to compete for investment capital. For example, FNMA and FHLMC are able to purchase mortgages in principal amounts significantly above the needs of moderate income families. These agencies are also able, via their Federal government "guarantees" and backing, to sell securities at yields lower than comparable yields of privately issued securities.

Third, other Federal and state laws and regulations, which are not addressed in S. 1821, restrict the flexibility of the private sector issuers. Many of those laws are not applicable to the federal agencies. An example of this is ERISA, which imposes constraints on the ability of ERISA qualified pension funds to invest in mortgage-backed securities.

In spite of these impediments, we believe that the private sector is ready and able to provide an increasing share of the investment capital needed to fund the housing finance demand. We see S. 1821 as an important factor in permitting this to happen.

ROLE OF THE FEDERAL AGENCIES

The housing industry is of great importance to Sears. Through its various companies and divisions, Sears is committed to providing quality products and services to this industry. As a private organization, we believe that Congressional actions, made in concert with the Administration's approach to deregulation, will provide increased competition in the financial services industry with the consumer being the ultimate beneficiary. Within this context, Sears seeks no special advantages as it competes in the private sector of the housing industry and, at the same time, does not believe that any special advantage or incentives should be granted to any competitor, public or private, without firm roots in the most compelling public policy.

When we look at actions taken by Congress to support the housing industry, we believe that the Federal mortgage agencies were created by Congress to provide a constant source of funds from the secondary market for mortgages to low and moderate income families. It was initially the intent of Congress that the agencies would facilitate and encourage lending institutions to make mortgage loans to the less economically advantaged, and begin to make all mortgage loan documentation consistent throughout the industry to create and enhance a new secondary market in these mortgages.

We appreciate the efforts and results of FNMA and FHLMC in these areas. However, we have seen the activities of these agencies expand beyond the initial Congressional intent. These entities have dominated the secondary mortgage market and can, by reason of the special benefits afforded them by the federal government, finance their operations at interest rates that are lower than comparable interest rates on mortgage related securities issued by private entities. Therefore, Congress should move cautiously and with due consideration to possible adverse consequences to the private sector before expanding the authority of those federal mortgage agencies.

COMMENTS ON CERTAIN SECTIONS OF S. 1821

Turning now to specific comments of S. 1821, Sears believes that Section 106 may be the most significant step taken by this bill. This section provides for the Federal preemption of state blue sky laws and legal investment laws and regulations. If enacted, this section would act to open up the market to a host of new investors in mortgage-related securities. This is because existing blue sky and legal investment laws, have dissuaded investors from making such mortgage investments. Most of these state laws were implemented prior to the advent of mortgage related securities.

Federal preemption of these state laws within the context of mortgage related securities will permit private firms the flexibility of offering mortgage investments quickly and efficiently while still retaining the safety associated with these investments.

In addition, meeting state blue sky and legal investment survey regulations adds considerable cost for the issuer of mortgage-related securities. If enacted it is likely that this cost saving can be passed on the invididual mortgagors.

Section 101 of the bill takes several steps to broaden the markets for both potential issuers of mortgage backed securities and potential investors. We have some concern that the quality of securities which should be maintained by the private sector may require some additional limitations.

It is our view, however, that the growth of the private sector will be greatly enhanced by the reduction of the minimum purchase amount at $250,000 and that an alternative approach to protecting unsophisticated investors would be preferred. We would propose that only mortgage securities in the two highest investment grades as defined by nationally recognized rating agencies be covered by this legislation. This will provide for a more efficient secondary market and assure that only the highest quality mortgage securities avoid the scrutiny of Federal or state regulatory authorities.

Section 105 would allow national banks to underwrite and deal in investment grade privately issued mortgage related securities. While we believe that this step would help to establish and maintain a better secondary market in privately issued securities, we also believe that such banks should be required to engage in this new activity only through a separate securities affiliate or subsidiary of the bank holding company. This approach is consistent with our position that expanded activities of banks be permitted but on the same basis as other firms.

Section 203 would allow FHLMC to purchase junior lien mortgages on the same basis as FNMA. We believe that it would be inappropriate for FHLMC to purchase junior lien mortgages other than those which can be certified to be used for home purchases or for home improvements.

Sears appreciates this opportunity to present our position on S. 1821. In addition, we also applaud Senator Tower and Garn for their legislative proposals contained in S. 1822. That bill would greatly encourage the growth of the private secondary mortgage market through Trusts for Investments in Mortgages ("TIMS"). Both bills create a favorable response to the needs of the housing finance industry.

We would be pleased to answer any questions that this Subcommittee may have.

Senator TOWER. Thank you, Mr. Reed.
Mr. Pope.

STATEMENT OF CLAUDE E. POPE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, GENERAL ELECTRIC MORTGAGE INSURANCE CORP., RALEIGH, N.C.

Mr. POPE. Thank you, Mr. Chairman and members of the subcommittee. I'm Claude Pope, chairman of the board and chief executive officer of General Electric Mortgage Insurance Cos., which are wholly-owned subsidiaries of General Electric Credit Corp. During the subcommittee's May 1983 hearings, General Electric Credit furnished detailed information about our role in housing finance and the economic realities of the secondary mortgage marketplace for private sector companies. At that time we pointed out the overwhelming competitive advantages possessed by our two federally chartered competitors, Fannie Mae and Freddie Mac, that presently limit private sector involvement in providing new capital investment for housing.

COMPETITIVE DISADVANTAGES

We are indeed pleased and encouraged by initiatives of the chairman and Senator Garn in proposing S. 1821 and S. 1822 to address the competitive disadvantages of the private sector companies and the efforts to create a more nearly level playing field for all competitors.

Because the proposed Trusts for Investment in Mortgages bill, S. 1822, must first be approved by the Finance Committee, I will limit my comments to S. 1821, although I do want to point out that we fully support the concept expressed in S. 1822.

G.E. Credit believes that the enactment of S. 1821 is an important first step in enhancing private sector participation in the provision of new capital investment in housing. We support passage of this bill in essentially its present form, although our written statement suggests a number of detailed technical modifications that we believe are desirable to insure that its intent is fully achieved. But due to the technical nature of much of this material and our time constraints this morning, I will not attempt to summarize those points. We will, of course, be most happy to respond to any questions and work with the subcommittee staff to resolve technical problems that may arise in connection with those issues.

PRESENT STATUTORY MORTGAGE LIMITS MUST BE MAINTAINED

As a private sector company with no special ties to the Federal Government, we must, however, expressly condition our support for S. 1821 upon maintaining the status quo with respect to Fannie Mae and Freddie Mac's operating authorities under their charter acts. In particular, the present statutory mortgage limits must be maintained or Fannie Mae's and Freddie Mac's special statutory advantages must be eliminated or there will be no remaining market in which truly private companies can take advantage of S. 1821 to compete with them.

The economic arguments on these points are irrefutable.

Let me turn very briefly to a few substantive comments on title I. We believe that the purposes of section 101 might be better served by raising the minimum qualification for noninstitutional issuers and reducing the minimum qualifying individual sale of a fractional interest in a mortgage-backed securities pool to $25,000. Such a modification would provide parity with Fannie Mae and Freddie Mac, which are now able under their statutory exemptions to sell their securities of denominations of as little as $25,000.

With respect to title II, G.E. Credit has practical concerns about expansion of Freddie Mac's second mortgage authority to loans for other than housing purposes. I would direct the subcommittee's attention to our detailed comments for further elaboration on this point.

Over the past several months, those who advocate increasing the statutory mortgage limits and otherwise expanding Fannie Mae's and Freddie Mac's authorities to new areas of business beyond residential real estate for low- and moderate-income Americans have postulated that benefits would flow to individual homebuyers, builders, realtors, and mortgage lenders. That may be true in the short run, but it ignores the realities of the extra costs that are generated for all Americans when the expansion of federally sponsored borrowings and securities issues drive up the cost both of our national debt and of competing private sector financing.

We must not lose sight, in our opinion, or ignore this *de facto* Federal subsidy for Fannie Mae, Freddie Mac, and Ginnie Mae. As a matter of public policy, we in G.E. Credit Corp. respectfully submit that Congress itself should decide how large a Federal subsidy the United States can afford for housing and who the recipients of that subsidy should be.

We are troubled that any further expansion of Fannie Mae's and Freddie Mac's powers under their special agency status may have the precise effect of making that decision for Congress at the expense of the private sector and precluding gaining control over either the cost to the public or the selection of which citizens will benefit.

Mr. Chairman, we at G.E. Credit appreciate this opportunity to further testify before this subcommittee in support of S. 1821. We will be most happy to answer any questions you may have. Thank you.

[The complete statement follows:]

STATEMENT
OF

CLAUDE E. POPE
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
GENERAL ELECTRIC MORTGAGE INSURANCE COMPANIES

Mr. Chairman and members of the Subcommittee, General Electric Credit Corporation appreciates this opportunity to address the secondary mortgage market enhancements proposed in S.1821 and welcomes the Subcommittee's efforts to support more private sector involvement in the provision of new capital investment in housing.

I am Claude E. Pope, Chairman of the Board and Chief Executive Officer of General Electric Mortgage Insurance Companies, which are wholly owned subsidiaries of General Electric Credit Corporation. During the Subcommittee's May 1983 hearings, General Electric Credit furnished detailed information about our role in housing finance and the economic realities of the secondary mortgage marketplece for private sector companies. At that time we pointed out the overwhelming competitive advantages possessed by our two federally-chartered competitors, Fannie Mae and Freddie Mac.

We are indeed pleased and encouraged by the Subcommittee's initiatives in proposing S.1821 and S.1822 to address the competitive disadvantages of the private sector companies vis-a-vis Fannie Mae and Freddie Mac and the efforts to create a more nearly level playing field for all competitors.

Unfortunately, however, S.1822's TIM's proposals are outside the legislative purview of the Committee on Banking, Housing and Urban Affairs, and there is no assurance that the priorities of the Finance Committee will permit S.1822 to be considered or approved during this session of the 98th Congress.

G.E. Credit believes that S.1821 - - with certain modifications that I will discuss - - is desirable and would in fact enhance private sector participation in housing finance. Our support, however, is expressly contingent upon maintaining the present statutory mortgage limits for Fannie Mae and Freddie Mac, and limiting both agencies' second mortgage purchase authority to second mortgages of $50,000 or less.

Without preservation of the existing statutory mortgage limits or elimination of Fannie Mae's and Freddie Mac's special statutory advantages, there is no remaining market in which truly private companies can compete with them. The economic arguments on this point are irrefutable.

Even if S.1821 and S.1822 were to be enacted in their entireties as proposed, G.E. Credit is convinced that the existing statutory advantages would still preclude effective private sector competition with these two Charter Act agencies. Accordingly, the present mortgage limits continue to be essential if there is to be private sector involvement.

Comments On S.1821

Turning to an analysis of the proposed Secondary Mortgage Market Enhancement Act of 1983, G. E. Credit notes that a number of securities law, S.E.C. regulatory policy, and ERISA compliance concerns are raised by this draft. In addition, although the TIM's legislation, S.1822, is not properly before this subcommittee at this time, it raises certain additional concerns under the Securities Act of 1933 and Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940 that are within the purview of the Banking, Housing and Urban Affairs Committee, and are interrelated to a thorough analysis of S.1821. We will advert to some of these concerns in our testimony.

Section 101: Amendments to the Securities Act of 1933

There are several terms used in the proposed amendments to Section 4(5) of the Securities Act of 1933 (the "1933 Act") that require further definition or replacement to achieve the intent of this bill.

The first of these technical matters is the meaning of the term "participation", which historically has been used in this context to refer to a bare fractional interest in a pool of mortgages. In contrast, the term "pass-through" security has been used to refer to an instrument which evidences an ownership interest in a pool of mortgages coupled with other elements, including various insurance coverages, advance obligations, repurchase obligations and reserve funds.

The third term "mortgage backed bond" generally refers to a debt security of the issuer which is a distinctly different form of mortgage-backed instrument from a "pass-through" security which, as noted above, represents an undivided interest in a pool of mortgages. Accordingly, in order to assure that "pass-through" securities are included within qualified obligations, it is suggested that "participation" be defined to encompass securities which include related insurance policies, reserve funds, rights in servicing contracts, and similar elements designed to assure servicing of, and payment under, such mortgage notes.

Finally, in recognition of the pending TIM's legislation, the definition of securities covered by Section 4(5) should be revised to assure that all mortgage-related securities which may be offered by a TIM are included. This objective would be aided by eliminating unintended differences in the definition of the securities eligible for issuance by a TIM and the class of securities exempt under Section 4(5) of the 1933 Act as amended by S.1821.

While the proposed expansion of the exemption from registration contained in Section 4(5) of the 1933 Act will be beneficial to the private sector, its full intent will not be realized unless it is made clear that each security offered pursuant to this exemption in its expanded form is a separate issue which is not subject to integration with a preceding or succeding offering made pursuant to the same exemption or to the private placement exemption of Section 4(2) of the 1933 Act, or which is made in registered form.

At the present time the Securities and Exchange Commission's most comprehensive statement on the general question of integration is set forth in Securities Act Release 33-4552 of November 6, 1962, which states that the following factors are relevant to the question of integration: whether 1) the different offerings are part of a single plan of financing, 2) the offerings involve issuance of the same class of security, 3) the offerings are made at or about the same time, 4) the same type of consideration is to be received, and 5) the offerings are made for the same general purpose. This criteria, when applied to mortgage-backed securities, provide a basis for concern since in the case of a series of issuances of mortgage-backed securities very frequently the last three of the above factors are clearly present, and the second is very arguably present due to the similarity of the securities and the existence of common packager, servicer and insurers, among other things, even though the underlying mortgages are unique to each pool. It is unclear how the first is to be applied (i.e., whose financing are we talking about), though it will typically be true that the different offerings are part of a single continuous plan so far as the packager is concerned.

Thus, although it may be argued that so long as an issuer avails itself of the Section 4(5) exemption, as distinct from the Section 4(2) exemption, in privately offering mortgage-backed securities, it need not be concerned with the "integration" question, the Commission has never officially endorsed this position. However, even if the Commission adopts this analysis, it seems unreasonable to limit the private issuance of mortgage-related securities to ones qualifying under Section 4(5) (i.e., requiring the purchase of a minimum of $250,000 principal amount, payment within 120 days after commitment, etc.), and it would still remain unclear whether a single packager, after issuing a series of pools to private investors in reliance on the Section 4(2) exemption, could then offer a pool to the public without concern that the previously privately-placed pools may be "integrated" with the public offering.

The objective of a statutory or rule change would be to provide that securities relating to a single body of mortgages would not be integrated with any other pool, notwithstanding that common packagers, servicers or insurers may be involved. While packagers and servicers contribute services to a mortgage which may affect payment, they are not themselves the basis for the ultimate credit involved. Furthermore, while insurance may contribute significantly to the credit worthiness of the issue, insurance policies themselves are not securities regulated by the 1933 Act (being exempted pursuant to Section 3(a)), and should not form the basis for the integration of different series of securities. Finally, the purposes of integration -- to prevent an issuer from making a public offering without registration by splitting such offering into a number of smaller private placements -- would not be served by integrating essentially separate securities in offerings made pursuant to a registration statement or exempt from registration under Section 4(2) or Section 4(5).

We also urge conforming amendments to the "issuer" definitions of the 1933 Act and the Securities Exchange Act of 1934 (the "1934 Act") to identify the "issuer" of various types of mortgage-backed securities. It is the Commission's current administrative position that, in respect to essentially passive trusts issuing pass-through securities, the "issuer" is the sponsor or packager, and not the pool itself. It should be noted parenthetically that the Commission will presumably continue to take the position that, on the contrary, for purposes of the Investment Company Act of 1940 (the "1940 Act") and the Trust Indenture Act of 1939 (the "1939 Act"), the pool itself, and not the packager, is the issuer.

Looking forward to the future enactment of TIM's legislation, we suggest that at that time the 1940 Act should be amended to specifically exclude from the definition of "investment company" in Section 3 thereof any entity which qualifies for TIM's treatment under the Internal Revenue Code and which limits reinvestments to investment of mortgage prepayments in obligations maturing no later than the latest maturity of any mortgage initially included in the TIM.

It would appear that the objectives to be achieved under the Tax Bill where reinvestment is so limited, and the policy concerns of the 1940 Act, have a substantial level of parellelism. Briefly stated, one area of exemption under the 1940 Act for companies principally engaged in the ownership of securities has been premised on a relative absence of active management. We would urge that, if the objective of the sponsors to put the private and public sectors on a parity with one another is to be achieved, it is essential that the private sector not be subjected to the burdens of 1940 Act compliance where the public sector is not so burdened, and the protections afforded to investors by the 1940 Act would not appear to be necessary in those TIM's where the power to manage and to vary the investors' interests are limited to that necessary to enable sponsors to afford to investors the greater certainty of maturity and yield with respect to the initial pool.

Beyond the redefinitions and collateral changes suggested above, G. E. Credit believes that Section 101 of S.1821 needs to be narrowed in two respects to ensure that only high quality issues of mortgage-backed securities will qualify for exemption under Section 4(5) of the 1933 Act as amended.

First, we are concerned that certificates issued by any HUD-approved lender would automatically qualify, provided they were "rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization."

Under Sections 203 and 211 of the National Housing Act, a mortgage lender who makes or invests in $1 million per year in residential real estate loans and who maintains a net worth of $100,000 is eligible for HUD approval. We question whether such limited criteria provide sufficient assurance to the investment community or would enhance the future viability of the mortgage-backed securities market as an intermediary for the delivery of investment capital for housing.

Second, regardless of which ratings agency's criteria are considered, no mortgage-backed security rated lower than the highest two ratings categories (e.g., Standard & Poors "AAA" or "AA") can reasonably be considered to merit treatment analogous to that accorded to such securities issued by Fannie Mae or Freddie Mac. We urge that Section 101 be so limited.

With respect to the parity issue, G. E. Credit questions whether the $250,000 purchase minimum in Section 101 is adequate, considering that both Fannie Mae and Freddie Mac are now able, under their statutory exemptions from S.E.C. registration, to offer and sell their mortgage-backed securities in denominations of as little as $25,000.

Sections 102 through 105

G. E. Credit is in general agreement with proposed Sections 102 through 105, subject to the foregoing discussion on the need to limit eligible investments to those rated in only the two highest rating categories.

Section 106: Preemption of State Law

G. E. Credit applauds the proposed limited preemption of state laws that limit the present sale of high-quality mortgage-backed securities to pension trusts and other organizations chartered under state and federal laws, subject to the specified state "opt-out" provisions.

Provided that the amendments to Section 4(5) of the 1933 Act are revised as we have suggested to cover only high quality private issues, opening up parity in placement of private mortgage-backed securities with securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae is entirely appropriate.

On a purely technical point, we assume that the reference in Section 106 to "paragraph B(1)" of the 1933 Act was a typographical error and that the reference intended was to paragraph B(i) of Section 4(5) as amended by S.1821.

Section 107

Although the S.E.C. has made permanent Rule 415, its so-called "shelf registration" rule, this section provides assurance against a future administrative reversal of position, at least so far as mortgage-backed securities are concerned. G. E. Credit supports this provision.

Title II

G. E. Credit takes no position on Sections 201, 202, and 205. We support Section 206 as proposed, as formalizing a reasonable restriction on Freddie Mac's ability to commit its guarantee to unrelated third parties.

Section 203

Because of G. E. Credit's own recent experiences in the secondary mortgage market in competing with Fannie Mae in the purchase of second mortgages that are not for purchase money, home improvement, or energy conservation purposes, we must oppose extension of such authority to Freddie Mac at this time.

At the very least, if such authority is to be granted, it should be expressly limited to the purchase of junior mortgages of $50,000 or less, and subject to the restriction that any such junior mortgage shall, when added to a primary mortgage owned by or placed in a mortgage-backed securities pool by Freddie Mac, not exceed the statutory mortgage limits set in the Charter Act. Identical restrictions should be placed upon Fannie Mae's authority, as has been provided for in H.R. 1, which has passed the House of Representatives.

Section 204

G.E. Credit must qualify its endorsement of section 204's proposed grant of manufactured housing purchase authority to Freddie Mac, based upon our more than twenty year's experience in this business.

With respect to so-called "unit" loans that involve both a security interest in the manufactured home and the real estate upon which it is located, we believe it is entirely appropriate to extend this authority to Freddie Mac, inasmuch as Fannie Mae already has such a program and the characteristics of such loans are closely analogous to the conventional mortgage programs in which Freddie Mac already possesses extensive expertise.

However, with respect to loans, advances, or credit sales secured by manufactured housing alone, G.E. Credit notes that most of the aspects of such lending -- appraisal, loan-to-value ratio, foreclosure risks, costs to recondition for resale upon default, cost of relocating the home, etc. -- are so unlike conventional real estate lending as to require entirely different underwriting and purchase assumptions and loan servicing practices if the financial security of such programs is to be assured.

In particular, strict controls must be established over seller/servicers and other participants if the present market acceptance of such paper is to be maintained and the existing vigorous private sector manufactured housing lending programs are not to be diminished or destroyed.

Such reasonable protections could be achieved either by appropriate regulatory review and approval requirements or by modifications to Section 204. G.E. Credit has no preference as to the methodology selected.

ERISA Considerations

Although matters relating to the Employee Retirement Income Security Act of 1974 ("ERISA") are within the purview of the Committee on Labor and Human Resources, there are certain aspects of the prohibited transaction provisions of ERISA that pose particular problems for private sector mortgage-backed securities issues. These provisions have not been dealt with by the Department of Labor in an administrative class exemption, as has already been done for Fannie Mae, Freddie Mac, and Ginnie Mae, and will potentially block achievement of investment parity by private issuers.

The proposed legislation contained in S.1821 and S.1882 does not consider the restrictions and requirements imposed by ERISA on investments by employee benefit plans. Such plans, often the source of substantial investments in pooled income funds, may be restricted in either the purchase of private mortgage-backed securities or in their involvement in the proposed trusts for investments in mortgages ("TIM's") by the prohibited transaction provisions of ERISA. The restrictions will apply unless the investments qualify under an administrative class exemption issued by the Department of Labor that is discussed below. Consideration should be given to whether the proposed legislation should be amended to include a statutory exemption similar to the exemption provided by the administrative action or provisions enabling employee benefit plans to invest in pooled mortgage investment trusts in situations other than those already permitted by the administrative exemption discussed below. The material that follows summarizes the restrictions imposed by ERISA and efforts made thus far to limit such restrictions.

Generally the prohibited transaction provisions in ERISA apply to certain transactions between or among employee benefit plans, parties in interest to the plans, and plan fiduciaries. In the context of a pooled investment trust, the first step in determining whether the prohibited transaction provisions of ERISA apply is to determine whether mortgage securities themselves or the underlying mortgages are considered "plan assets" of the employee benefit plan which has purchased such securities. Under the current position of the Department of Labor, if an employee benefit plan invests in either a "mortgage pass-through" security or a "mortgage-backed" bond, the underlying mortgages and related insurance coverages, advance obligations and reserves are considered plan assets unless a specific exemption or a class exemption is available. This result follows regardless of the percentage of the trust owned by employee benefit plans.

Proposed plan asset regulations (announced by the Department of Labor initially on August 28, 1979 and subsequently revised to reflect, at least in part, industry comments) have been submitted to the Office of Management and Budget in draft form. The proposed regulations would provide that assets of a TIM or similar pooled trust would be considered plan assets only if employee benefit plans hold more than 80 percent of the equity interest in the trust. Trust assets would not be considered plan assets if the aggregate equity interest of employee benefit plans is less than 50 percent of the trust. If the equity interest of employee benefit plans is between 50 and 80 percent, the trust assets would be plan assets only if a single plan investor or a single related group of such investors holds 25 percent or more of the equity interest.

If any assets of a trust are considered plan assets under the current position of the Department of Labor, or under any regulations (in whatever form finally adopted), an examination would be required to determine if any person or entity selling assets to the trust, providing services to the trust, providing financing for the assets acquired by the trust, an obligor on any assets acquired for the trust, or the ultimate consumer of the investments in the trust, is a party-in-interest (including, but not limited to a fiduciary) with respect to the plans involved. If any of these is a party-in-interest to the plan, the prohibited transaction provisions of ERISA may apply.

Reference is made to the discussion in the notice of a proposed class exemption on mortgage pool investment trusts published on May 6, 1980 in 45 FR 29937. The notice of proposed exemption illustrates the sort of examination which would have to be undertaken with respect to each pooled investment trust if an administrative or statutory exemption is not available. The class exemption considered in the notice was issued in final form as PTE 81-7 on January 6, 1981 (46 FR 7520) and amended by PTE 83-1, issued on January 7, 1983 (48 FR 895).

PTE 8301 exempts the initial issuance to and the sale, exchange, transfer, and continued holding by an employee benefit plan of certificates in a mortgage pool from certain prohibited transaction provisions of ERISA, provided that no more than fair market value is paid for the certificates and that the rights of the plan purchaser are not subordinated to the rights of another investor in the mortgage pool. The class exemption also exempts transactions where the sponsor, trustee, or insurer of a mortgage pool is a fiduciary with respect to a plan and transactions involving servicing arrangements with a party-in-interest, provided certain restrictions are observed. All of the exemptions provided by PTE 83-1 are subject to three conditions: (1) the sponsor and trustee for each mortgage pool must maintain a system of insurance or other protection for the pooled mortgage loans and the property securing such loans, and for indemnifying certificate holders against reductions in pass-through payments due to defaults in loan payments or property damage; (2) the pool trustee must not be an affiliate of the pool sponsor; and (3) the amount of the payments made to and retained by the pool sponsor together with other benefits inuring to it must not represent more than adequate consideration for selling the mortgage loans plus reasonable compensation for services provided by the pool sponsor to the mortgage pool.

If an investment by a plan in a trust, as currently proposed, does not meet the fairly strict requirements of PTE 83-1, the investment may be prohibited by the provisions of ERISA. PTE 83-1, it should be noted, defines the obligations in which a mortgage pool may invest in a much more limited fashion than the currently proposed provisions of S.1822. There is a real possibility that an entity qualifying as a mortgage pool under the proposed legislation would not qualify as such under PTE 83-1. Furthermore, it should also be noted, that it may be difficult to ascertain with any degree of certainty if the exemption does not apply, if all of any plan's parties-in-interest have been identified prior to engaging in a transaction which may subsequently prove to be prohibited. It would be desirable, therefore, to provide an ERISA exemption under the proposed legislation for any mortgage-backed security (whether it takes the form of a mortgage pass-through security or a mortgage-backed bond) or for any of the securities of any entity that qualifies for TIM's tax treatment.

Summary of Economic Argument

As G. E. Credit Corporation pointed out in our May 5, 1983, testimony, Fannie Mae and Freddie Mac presently enjoy three overwhelming statutory advantages over their private competitors in the issuance of mortgage-backed securities with respect to loans conforming to the Charter Act limitations. These are: (1) the agencies' special relationship with the United States Treasury, (2) their exemption from S.E.C. registration requirements, and (3) their effective exemption from state blue sky and fiduciary investment laws. In addition, there is the ERISA prohibited transactions exemption that operates in favor of Fannie Mae, Freddie Mac, and Ginnie Mae, that we have discussed today.

While S.1821 seeks to reduce or eliminate the second and third advantages detailed above, it does not affect the special relationship with the Treasury or the ERISA problems. Accordingly, G.E. Credit Corporation must condition its support for S.1321 expressly upon continuation of the present statutory mortgage limits.

Let me demonstrate the magnitude of Fannie Mae's and Freddie Mac's commanding advantages due to the cost savings achieved because of their federal agency status.

During 1982, Fannie Mae's new debt obligations were sold at yields between 35 and 90 points (.35 to .90 percentage points) higher than comparable Treasury securities, closing 1982 at about a 30-45 basis point spread. GECC's comparable cost of borrowing on our triple-A rated debt obligations approximates 50 basis points higher than Fannie Mae's borrowing costs, or about 85 to 90 basis points above comparable Treasuries. This translates to a one half of one percent cost differential in favor of Fannie Mae in what it must pay for funds on the open market, and this lower cost is due entirely to Fannie Mae's special Charter Act status.

A well run mortgage-backed securities program should incur only limited debt carrying costs, for a period of perhaps 45 to 90 days, to hold the purchased mortgages briefly pending completion of the pool and sale of the resulting certificates to the ultimate investors. But Fannie Mae's cost advantages carry through to the yields Fannie Mae must pay in marketing its mortgage-backed securities, and those yields translate directly to the price Fannie Mae can afford to pay the mortgage originators from which it purchases mortgages.

This point can best be illustrated by looking at the August 19, 1983, yields on Fannie Mae's 12% conventional 30-year mortgage-backed securities at 12.94 percent and Bank of America's 12% conventional 30-year mortgage pass-throughs (rated "AAA"), yielding 13.57 percent, for a spread of 63 basis points. In order to reduce this spread and remain competitive in the market place, a private sector issuer must either develop methods to lower its packaging costs or reduce the yield it pays to the mortgage originator on mortgages purchased for pooling.

Since mortgage originators shop aggressively to obtain the lowest possible yields available when selling their mortgages in the secondary market, any incremental costs that private sector competitors must pay necessarily reduces private issuers' ability to compete successfully in this market with federally subsidized agencies. Between the higher yields that private issuers of mortgage-backed securities must pay to investors and the additional costs enumerated above, the private sector has effectively been precluded from operating in the secondary market for mortgage loans of $108,300 or less.

Unless Fannie Mae and Freddie Mac are prevented from using their federal subsidies in competing for jumbo mortgages in the secondary market, any increase in their loan limitations will *de facto* limit or preclude entirely the participation of the private sector in this market. Nor is the size of the top-end conventional mortgage-backed securities of any practical impact -- $5.6 billion or $12.8 billion -- Fannie Mae and Freddie Mac will effectively out-bid unsubsidized private sector competitors.

Fannie Mae's aggressive entry into the secondary market for second mortgage loans of up to $108,300 graphically illustrates how powerful the agency status economic powers really are.

At year end 1981, Fannie Mae owned less than $200 million in second mortgages. In 1982, Fannie Mae bought $1.6 billion in second mortgages and has bought an additional $906 million in the first half of 1983 alone.

G. E. Credit has been an active participant in the private second mortgage market since 1970, both originating second mortgages directly to consumers and buying portfolios of second mortgages originated by others. Many other leading private financial companies have also been active in this area, including Beneficial Finance and Household International, among others. G. E. Credit's present total portfolio of second mortgages amounts to $600 million, only a portion of which were purchased in the secondary market.

From this data, it is apparent that Fannie Mae's more than $2.5 billion portfolio of second mortgages already makes it the dominant player in the secondary market for second mortgages. One industry publication, U. S. Housing Markets, has developed a financial analysis clearly suggesting that Fannie Mae possessed 75 percent of this secondary market at year end 1982. Not bad for a new entrant!

How did a new player establish this dominance over an established industry so quickly? By taking advantage of its special Charter Act status and its ability to sell debt obligations more cheaply than any private competitor can, and by using that price advantage to undercut every other company buying second mortgages.

Nor is this statutory competitive disadvantage for the private sector confined to the secondary market. Any private company originating second mortgages for its own portfolio must now compete on interest rates with mortgage bankers and others who originate second mortgages solely for sale to Fannie Mae. Since Fannie Mae is presently buying fixed-rate second mortgages of up to $108,300 at yields of only 37.5 or fewer basis points above conventional first mortgages, it is becoming problematic whether private competitors can maintain a sufficient spread above their higher money costs to warrant remaining in this business.

We believe that any expansion of Fannie Mae's or Freddie Mac's authorities to new areas of business under their special Charter Act status will have precisely the same effects upon private competitors and will ultimately convey monopoly power to these agencies.

Conclusion

In the final analysis, G.E. Credit Corporation respectfully submits that it must be the Congress that decides, as a matter of public policy, how large a federal subsidy the United States can afford for housing and who the recipients of that subsidy should be.

We are troubled that any further expansion of powers for Fannie Mae or Freddie Mac under their special agency status may have the precise effect of making that decision for Congress, at the expense of the private sector, and preclude gaining control over either the costs to the public or the selection of which citizens will benefit.

G. E. Credit appreciates this further opportunity to appear before the Subcommittee and share with you our concerns about S.1821. We will be happy to work with staff to provide further responses to any technical questions and to suggest appropriate language to implement provisions we have suggested.

Senator **Tower**. Thank you, gentlemen.

Reference has been made to the special status of Fannie Mae and Freddie Mac, but there are some concerns that have been expressed in terms of the entry of the private sector into this field.

Let me recite testimony provided by the National Association of Homebuilders which states that private entities cannot be expected to perform the countercyclical role of the federally chartered agencies nor can they be expected to provide the nationwide market that the agencies were chartered to provide.

COULD THE PRIVATE SECTOR BE FAIR-WEATHER FRIENDS?

My question, gentlemen, and I'll ask each one of you to comment on it if you would like to, is, How do you respond to this and what can you say to allay the fears of the National Association of Homebuilders and others that harbor similar ideas so that they won't consider the private sector to be little more than fair-weather friends? Further, what can you tell us about the geographic distribution of the mortgages you purchase?

Mr. **Beal**. Mr. Chairman, Residential Funding Corp. has over 1,600 correspondents throughout the United States. Norwest Mortgage has been in business since 1906. It is in the mortgage business only. It's been committed to staying in the business through 1929 and every other adverse year, and our commitment won't end.

Mr. **Reed**. Mr. Chairman, it's our feeling that the private market performed during the most recent downturn in the economy in

1981 and 1982, a period in which many believe the housing market approached depression kinds of statistics.

In the secondary marketing activities of private companies, there was never a lack of availability of funds. There was only a lack of availability of an interest rate at which borrowers could qualify.

It is our feeling that the private market did stand by the housing sector, but obviously we can't afford to subsidize interest rates at the expense of our own profitability.

Senator **Tower**. Mr. Pope.

Mr. **Pope**. Mr. Chairman, first, I guess I would at least raise the question as to whether or not the agency roles have been more than just countercyclical in nature at times.

Aside from that, I think the record is well documented about the efforts of General Electric Credit Corp. in the broad real estate spectrum in all of the States of this country and, just as Mr. Beal stated earlier, our program is designed to geographically cover the entire country, not just one State or one city or one region.

We have every reason to believe that with the passage of the enhancements, afforded by the bills before this committee that we will be in a position to stay in the marketplace on a broad geographic basis throughout the real estate cycles.

Senator **Tower**. Thank you. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

TIMEFRAME FOR PRIVATE SECONDARY MARKET DEVELOPMENT

Mr. Reed, on page 4 you say, "It will take time for these private companies to issue mortgage-related securities in the volume sufficient to develop an active and sufficient secondary market," and I think that that might be a generally shared view at the table so I welcome the response of all of you. But I'm wondering, as you consider the market and your likely competitors, how long do you think it will take under current conditions for a private secondary market to develop to something close to its full size potential? In other words, where would we be, say, 2 years or 5 years down the road? I'd like an estimate from each of you.

Mr. **Reed**. Our estimate is in 5 years that the private sector will account for approximately $30 billion a year in private mortgage securities issued. To develop an active secondary market in any security, whether it be a corporate debt instrument, a stock or a mortgage security, there needs to be sufficient volume of an issue outstanding to stimulate investor interest in a viable secondary market to trade those securities as their portfolio needs change.

I think that some of the testimony that you will hear from the investment bankers later this week will support that, but it's our belief that a billion dollars' worth of securities is required before the market pays attention. We believe that that can happen and it should be allowed.

Senator **Riegle**. Now you're saying that you're still setting a figure of roughly $30 billion, 5 years out. How do the others feel?

Mr. **Beal**. First, I would say the answer would depend upon whether or not there's a signal from Congress that the private industry is really encouraged to enter the market. If Fannie Mae and Freddie Mac are going to be given the entire market, there will be fewer participants from the private sector. Based on the assumption that Fannie Mae and Freddie Mac are limited at their present loan limits, then we feel there is virtually an unlimited amount of ability from the private sector to handle the housing needs.

We already have issued conventional passthrough securities in excess of $3 billion. We feel we have liquidity in our product now. We feel it will be beneficial to the whole industry if more private corporations are allowed in. As we assume they are allowed in and encouraged to come in, we think they can handle as much of the market as there is market to handle.

Senator **Riegle**. Do you have any internal projections for 2 years out, 5 years out, in total of your own outfit that you could help us size up a little?

Mr. **Beal**. Our projections are based on the same studies that other people's projections are based on. We assume that the conventional passthrough securities—the assumption that somewhere near 70 to 75 percent of the market will be handled in the secondary market and not by portfolio lenders, and also that approximately 70 to 75 percent of the loans are conventional versus FHA and VA, that the market for conventional passthrough securities by 1985 to 1987 will be approximately $200 billion.

Our concern is if private industry doesn't handle that $200 billion, is Congress really willing to let Fannie Mae and Freddie Mac increase the size of Government agency debt by $200 billion a year? I think it's very, very important that Congress see early that it's essential that private industry of necessity take over that obligation.

Senator **Riegle**. You're not sizing that market based on the assumption that you're just talking about mortgages over $108,000, are you?

Mr. **Beal**. No. That's the entire market.

Senator **Riegle**. And that's another way of saying that you intend to participate in the entire market?

Mr. **Beal**. Yes, sir.

Senator **Riegle**. So that mortgages up and down the dollar scale will be part of the blend that you would anticipate. Is that right?

Mr. **Beal**. Assuming that all benefits of S. 1821 and S. 1822 are enacted; yes, sir.

Senator **Riegle**. Do you want to add anything to what's been said, Mr. Pope?

Mr. **Pope**. Well, I tend to agree with much of what I have heard. We certainly anticipate operating in the broader spectrum of the market subject to the passage of this legislation; and absent that, we obviously feel at a very competitive disadvantage vis-a-vis our Federal competitors.

The projections that you have heard, I think, are entirely realistic. We think the potential in the market is almost staggering, given the opportunity to effectively compete. And, as Mr. Beal just stated, somehow we cannot conceive of the Congress allowing the agencies to expand their operations in the volume that would be needed to finance housing absent private sector involvement.

REMOVAL OF LEGAL DISADVANTAGES

Senator **Riegle**. Let me ask you this, Mr. Reed. Also in your statement you make the point that we should remove legal disadvantages that now hinder private issued mortgage related securities, and I agree with that; and you say on page 3 that "The privately issued securities should be placed in the trading position on par with similar corporate securities and closer to agency issued securities." That's a quote.

But the bill as it's now drafted, it seems to me, provides some important advantages—exemption from SEC registration, net capital requirements for broker-dealers, investment authority for thrifts and national banks—and it seems to me that things like this may give these securities, if anything, maybe a superior trading position to similar corporate securities.

I'm wondering if that's necessary, to go out and compete against corporate securities, and I'll just finish by saying that I think if we decide there's an overriding public purpose in terms of promoting housing in the country, which is something that many of us feel strongly about, many could argue that even if that's the case, fine, let's do it, because it serves the public purpose and basically we want to move things that way.

But I'm wondering if, in fact, that meets the suggestion that, in fact, we're really on a level playing field or we're working if we're working in a par situation rather than one that may have some advantages your way.

Mr. **Reed**. Senator, we are not looking for any specific advantage over any other private issuer of any kind of corporate security and we feel that this bill will remove several of the obstacles or things that currently put us at a disadvantage either from a cost point of view or from a trading point of view in the marketplace with agency competitors. But there are additional things such as ERISA which aren't dealt with in this bill or in S. 1822 that make it difficult for mortgage security issuers to tap the pension fund market. This is one example of being on par in that there are fewer restrictions on corporate debt issuers.

Senator **Riegle**. Would either of you other two like to respond? [No response.]

Senator **Riegle**. Well, if I may, Mr. Chairman, let me ask one more question here.

I'm sensitive to your point on the ERISA thing and I think we've got to find a way to deal with that complication.

CAUTION IN REMOVING LIMIT ON MORTGAGES

I want to address finally the question of the $108,000 limit on mortgages and the fact that you all expressed the caution about whether or not the Congress should let Freddie Mac move above that level.

As you know, there are a number of national housing organizations that suggest those limits should either be taken off completely or certainly raised, and as we've seen what's happened to housing prices and as we know what happens from market to market where you can have precisely the same house in one market with a value that's substantially higher than that house in a different market, that you're running into a situation where an arbitrary ceiling like that has an altogether different meaning and implication, say, in the California type of situation or, for that matter, even in areas adjacent to Washington, D.C.

I'm just wondering, as you size the market in the future of mortgages above $108,000 and mortgages below $108,000, how much of the market do you see splitting off on both sides of that line? I'm wondering how fixed we should become on that as some kind of an iron boundary if it's adjusted even modestly that somehow sort of changes everything and makes this proposal less workable than perhaps some adjustment that could be accommodated and might in fact make sense.

Mr. **Beal**. Senator, today, approximately 92 percent of loans qualify for $108,000 or less. That's based on the fact that 92 percent of homes sell for $120,000 or less.

We feel that Government, again with Congress, has a real decision to make. How much subsidy is going into housing versus the other industries in the country—agriculture, specific industries such as Chrysler, Lockheed?

Senator **Riegle**. Chrysler is no longer a client, by the way. [Laughter.]

They paid back and they're out and made a big profit.

Senator **Tower**. Neither is Lockheed.

Mr. **Beal**. Well done.

Senator **Riegle**. We still have some others.

Mr. **Beal**. It shows that some industries need assistance in addition to housing.

We feel that Congress needs to say how much Government guarantee of private debt should be allocated to housing. Is allocating 92 percent of the total housing market sufficient? Our assumption would be it would be better to be at 50 percent of the market and that, in fact, instead of discussing whether or not the limits should be raised, they should be lowered appreciably.

Senator **Riegle**. My time is up, but I don't want to truncate any answer here.

Mr. **Reed**. Senator, we agree with Mr. Beal's 92-percent limit and if the private market is allowed to develop or is to be encouraged to develop, it is necessary to allow a sufficiently large market segment for us to be able to compete profitably and to generate a sufficient volume of mortgages to prove that the private sector can in fact support a greater portion of the Nation's housing needs.

Our purpose is to invest mortgage money in high-cost areas and our program is designed to do that, although we would welcome the opportunity to include low balance loans under $108,300 in our program. But we cannot compete with the agencies on a yield basis on loans below $108,300. This is because of the Federal agencys' inherent advantages previously discussed. Our experience with the securities we've issued in the past is they have been targeted specifically to high-cost areas in California and Texas and some other areas, and we feel that we can continue to support that segment of the market very effectively.

Senator **Riegle**. Although I did think I heard you say earlier that you planned to have in a portfolio a balance of mortgages, so you're not talking about just mortgages above $108,000; you're talking about those that would fall below that level.

Mr. **Reed**. We currently have mortgages in our portfolio that are below $108,300 and we would be delighted to purchase loans below that level. There are more profitable opportunities for most mortgage originators for loans below $108,300. They can go to Fannie Mae and Freddie Mac.

Senator **Riegle**. Thank you, Mr. Chairman.

Senator **Tower**. Senator Proxmire.

Senator **Proxmire**. Mr. Beal, I noticed you were the clearest and most emphatic of the three witnesses in indicating that it would be necessary if you are going to succeed and if the private program we're discussing this morning is going to have any chance of success to limit, as Senator Riegle has pointed out, Fannie Mae and Freddie Mac to $108,000 and limit them, as you said, to serving of low- and moderate-income sectors. You said that's 92 percent. That's a pretty big chunk.

I take it that all of you gentlemen agree with that, although I didn't hear Mr. Reed say that specifically. I take it you agree with that.

Mr. **Reed**. Senator, we agree with that.

Senator **Proxmire**. I know Mr. Pope does. How would you gentlemen feel if these agencies were privatized to the extent of not having any Federal backup?

Mr. **Beal**. Well, we feel that the Government does have the need to support low- and moderate-income housing. We think one agency that's a pure Government agency, not a private corporation trying to serve two masters, should be the agency that serves the Government purpose. We think that's Ginnie Mae.

PRIVATIZATION OF FNMA

We strongly support a complete privatization of Fannie Mae, eliminating all ties to the Government, allowing it to compete in the market based on its own abilities. We have proposals in our testimony as to how we think that could be accomplished successfully.

Senator **Proxmire**. I'm sorry. I must have missed something. You indicate that we should have a Government agency that would provide——

Mr. **Beal**. One Government agency.

Senator **Proxmire**. One Government agency.

Mr. **Beal**. Ginnie Mae.

Senator **Proxmire**. All right. Very good. Any difference of opinion on that?

Mr. **Pope**. No, sir. We would welcome the opportunity to compete with these agencies if they were privatized. Although we do feel that there is a role in housing for Government, it needs to be modified in such a manner that it does allow room for private involvement.

Senator **Proxmire**. Now, Mr. Pope, you discussed the difference between S. 1821 and S. 1822 to some extent. If it's not possible to get quick action on the Trusts for Investment in Mortgages bill, S. 1822—that's the one I guess that would maybe be the most decisive in helping you—but we may not be able to get quick action on that.

It's not in the jurisdiction of this committee. What about passing S. 1821 which is? Would this action by itself have a significant effect on expanding the secondary mortgage market, in your view?

Mr. **Pope.** I think, Senator, that there has to be a first step in any process and passing S. 1821 would be a very important first step that would definitely enhance the secondary market, but with the specific condition of our lack of support for raising the Fannie Mae and Freddie Mac loan limit. Because, even if you pass this legislation, if you don't allow us to compete with the agencies, then I don't think we've accomplished much to enhance the private sector.

Senator **Proxmire.** Mr. Reed, can you give me an estimate of the potential increase in the supply of mortgage funds in your view over the next, say, 5 years or so if these two bills are enacted?

Mr. **Reed.** Senator, that would be very difficult to do.

Senator **Proxmire.** Let me just interrupt my question and ask it a different way because I understood one of you gentlemen pointed out that we have had sufficient funds in the past but the interest rates have been what's discouraged homebuyers and killed the market.

Maybe you can give me an estimate as to what effect this might have on the rate of mortgage interest.

Mr. **Reed.** Senator, I believe that this bill will encourage more mortgages to be converted from home loans in mortgage pools and that will have the impact of attracting additional sources of funds into the housing market. This would encourage the pension funds that were mentioned earlier to significantly increase their percentage of investments in mortgages.

Senator **Proxmire.** Could you put a number on that significantly?

Mr. **Reed.** If we could get them to 5 percent of assets that could be $50 to $75 billion. More significantly it would be an increase to 10 percent of assets.

Senator **Proxmire.** Mr. Beal, could you give us an estimate?

Mr. **Beal.** We believe that—we trade about 70 or 75 basis points over Ginnie Maes now. These enactments could allow us, we believe, to get down to 30 or 35 basis points. That improvement of three-eighths would be the yield improvement. That was one of your questions.

The other, we believe the availability of additional investors that these two bills would permit should be in the range of $200 billion in the next 3 or 4 years which we perceive is what the private market can handle.

Senator **Proxmire.** Mr. Pope.

Mr. **Pope.** Senator, I do not have a specific figure in mind, but certainly firmly believe that the passage of this legislation will greatly expand the markets for the sale of mortgage backed securities, whether it is to pension funds that have been reluctant to buy or even individuals themselves that could more readily invest in the mortgage market through the passage of this bill. I would be glad to give you a quantified figure later if you would like.

Senator **Proxmire.** Perhaps you could do that for the record.

[The following information was subsequently supplied for the record:]

General
Electric
Mortgage
Insurance
COMPANIES

Claude E. Pope
Chairman and Chief Executive Officer

December 7, 1983

The Honorable William Proxmire
United States Senate
531 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Proxmire:

During the September 21 proceedings by the Committee on Banking, Housing and Urban Affairs on S 1821, you asked that I supply additional information concerning the increase of private mortgage backed securities (MBS) issues and decrease in mortgage yields if S 1821 and S 1822 are passed.

It is my belief that with the passage of the above referenced legislation we might, within a few years, expect on an annual basis to see private MBS issues in the range of $125 to $250 billion. I further believe that all of this can be accomplished with an overall yield reduction of approximately 3/8% + or -.

It is obviously difficult to make a forecast of this nature. Even if we can only obtain the low side of my forecast on an annual basis, the legislation is well worth passing.

Attached is some information that helps substantiate the thoughts I have expressed above.

Thank you for giving me the opportunity to testify on September 21 and also for allowing me to make this additional information available.

Sincerely yours,

CEP/jwr
0228J

✓cc: Edward M. Malan
+ attachments

5401 Six Forks Road, P.O. Box 177800, Raleigh, North Carolina 27619 919/782-7810

Supplemental Information on
Testimony for S.1821

According to industry figures at year-end 1982, holdings in mortgage-backed securities totalled $188.2 billion amongst thrifts, commercial banks, state and local governments and agencies, federally-sponsored agencies, and non-traditional investors. These mortgage security investment holdings by investor-type includes:

(in billions)	
Savings and Loans	$64.4
Mutual Savings Banks	15.1
Commercial Banks	10.9
State and Local Governments and Agencies*	7.6
Federally-Sponsored Agencies	--
Non-Traditional Investors**	90.1

Other noteworthy points regarding mortgage holdings are:

o According to HUD statistics, there were $938.0 billion in residential mortgages outstanding at the end of last year.

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*Agency holdings are shown as whole loans, those of government general funds as securities.

**Includes: Life insurance companies, private pension funds, state and local retirement funds, mortgage and finance companies, credit unions, real estate investment trusts, corporations and partnerships, U.S. government holdings of FmHA-related obligations, and bank trust holdings of mortgage-backed securities.

- Of that $938.0 billion, 74.8 percent, or $701.9 billion, was held by depository institutions -- that is, savings and loans, mutual savings banks and commercial banks. (Savings and loans themselves held 48.4 percent of all mortgages.) Depositories held 87.1 percent of their mortgages in direct form, and 12.9 percent as MBS.

- So-called "nontraditional" investors -- principally life insurance companies and pension funds -- held 12.6 percent of all mortgages in 1982. MBS accounted for 76.5 percent of those holdings. However, since the figures were first collected in 1970, all the nontraditional investors' net increases in mortgages have taken the form of MBS. That is, total holdings have risen by $79.1 billion, while MBS holdings have increased by $88.0 billion.

- Of the $938.0 billion in total mortgages outstanding as of year-end 1982, $749.8 billion or 79.9 percent were held directly, while $188.2 billion or 20.1 percent were held as MBS. Since 1976, total mortgage holdings have risen by $445.0 billion; MBS have increased by $146.7 billion, thus accounting for just about one-third of total mortgage growth during that period.

- Of the $188.2 billion in MBS outstanding as of year-end 1982, $115.3 billion or 61.3 percent were GNMA's, $20.0 billion or 10.6 percent were FmHA's (sold as pools to the Federal Financing Bank), $32.5 billion or 17.3 percent were FHLMC's, $14.5 billion or 7.7 percent were FNMA's, and $6.0 billion or 3.2 percent were privately issued security.

Privately issued securities are currently trading about 1/2 to 3/4 of 1% over Ginnie Maes. A yield improvement of 1/4 to 3/8 of 1% can feasibilily be attained as a result from a reduction in issuance costs for MBS.

Pension funds would be the investor group which would realize the most benefits from passage of these bills. Currently, the combined assets of pension funds total $1,500 billion. As mentioned previously, the fund's holdings growth in mortgage securities has exploded in recent years. Yet, as a percent of their total assets, mortgage investments are quite insignificant. However, with the removal of restrictions inhibiting their ability to invest in mortgages, it would be reasonable to expect that pension fund holdings in private MBS issues may increase to approximately $75-150 billion within five years. In addition to this increase, another $50-100 billion in MBS issuances can be expected in other investor categories.

Data Sources:
1) "The Multifacited Revolution in Securitizing Residential Mortgages" by J. Hu. Published by Salomon Brothers, Inc
2) "The Secondary Residential Mortgage Market" by J. Hu. Published by Salomon Brothers, Inc.
3) "Two Measures of Residential Mortgage Market for Housing Roundtable". Published by the Federal National Mortgage Association.

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Senator PROXMIRE. Do you believe, Mr. Pope, that other companies will enter the business of the secondary market as you have if these two bills are passed?

Mr. POPE. Yes, sir. I think we would see a number of additional private competitors in the marketplace.

Senator PROXMIRE. Do you agree, Mr. Beal and Mr. Reed?

Mr. BEAL. Yes, sir.

Mr. REED. Yes, sir.

Senator PROXMIRE. Thank you. Thank you, Mr. Chairman.

Senator TOWER. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

My first question was just asked by Senator Garn, the question of affordability which is—I meant Senator Proxmire—I'm sorry, Bill. There's no comparison at all.

Senator TOWER. Please keep that in the record.

Senator PROXMIRE. He's the chairman. I feel flattered.

Senator DODD. That's what I was thinking of.

Senator PROXMIRE. He has yet to have his transplants, too.

Senator DODD. I didn't say that at all. [Laughter.]

At any rate, the availability and affordability question is really what interests I think all of us up here and there is somewhat of an analogy with the Garn-St Germain bill of last year with the thrift industry in this sense. We had mandated by law that the thrift industry do certain things and for a variety of reasons that we're all familiar with we got in trouble and we decided it was in everybody's interest to try and help them out and get them back on their feet again and obviously help housing, which is the major issue affecting them. So we came up with these enhanced powers during that period of time to assist them.

In a sense, I don't know how accurate or up-to-date these statistics are, but some $52 billion of the present obligations of Fannie Mae are yielding 9.5 or 9.6 percent. That's a substantial loss and I agree we should privatize them if we can.

The question becomes, in addition to the important role the private sector plays, how can we get them healthy when in fact they've been doing what we insisted that they do.

And while I'm sensitive to your concerns about them getting additional assistance from us that competes unfairly with the private sector, it seems to me it's in all of our interests that they be healthy. It's important that there be a Fannie Mae and Freddie Mac out there and hopefully a private Fannie Mae and Freddie Mac.

How do we get them in that position so that they're whole since in effect we're responsible for the situation they're in? Do you understand what I'm driving at?

Mr. BEAL. Senator, our suggestion would be that take the lowest $50 billion of earning assets, the lowest $50 billion of Fannie Mae debt, transfer it to Ginnie Mae, and at the same time sever all ties between the Government and Fannie Mae. It would then have a balance sheet similar to a very large S&L or a large bank would have, the same capital ratios that a bank or a savings and loan has, and it should be able to operate as successfully as savings and loans because it would have sufficient equity to support the remaining assets.

The need that the Government has to support lending could be done through a pure Government agency that does have proper incentives, and that's Ginnie Mae.

Senator DODD. Do either of you other two want to comment? The question is principally how do we make them whole? That's one suggestion.

PROVIDE RELIEF FOR LOANS IN FNMA PORTFOLIO

Mr. REED. Senator, I think that Freddie Mac is whole and that the real issue is with Fannie Mae. I believe that Fannie Mae needs to be made whole and that the only way in a short period of time that they can be made whole is to provide some form of relief for those loans in their portfolio which are currently under water.

The other thing that does not help them perhaps in the long range is to continue to add 30-year fixed rate loans to their portfolio and finance them with short-term debt.

Senator DODD. Isn't that going to be—I appreciate what you're saying, but that could be a sizable Federal obligation that must occur to inject whatever number of billions of dollars to do that rather than suggesting giving them a bit more piece of the action in effect, which is what you're opposed to? I understand that, but wouldn't that be a fiscally wiser way for us to proceed?

Mr. REED. I don't believe so. I don't believe that Fannie Mae's participation in that market segment which we are currently aiming at will add significantly to curing their current spread.

Senator DODD. Mr. Pope.

Mr. POPE. This is obviously just a Fannie Mae problem at this point and the magnitude of that problem is already there today, whether it's a $7 billion problem or an $8 billion problem or whatever that figure is.

Now I certainly, for one, hope that the programs of the board and the officers and employees of Fannie Mae are going to be very successful, but when I look at their own figures and what has taken place just this year and see that even at the high level of home loan interest rates today that the monthly average net yield on their portfolio in 1983 in the first 6 months declined by seven basis points, and when I see that and the type of environment that we are in, it does raise a big question in my mind as to whether or not they can successfully on their own dig out of the hole. With the probability that that is not possible, I can't see how allowing them to just make more larger loans is going to do anything except possibly make the problem worse if these programs don't work as they have. So I would suggest that there is an immediate need to address the seriousness of the problem.

COMPETITION WITH FNMA

Senator DODD. All three of you I think suggested at one point or the other that you would like to compete with Fannie Mae at mortgage levels below $108,000, yet you don't really want them to compete in mortgages above $108,000. In effect, if we leave that ceiling on and suggest that that's how they make themselves whole by dealing with that particular level of financing, isn't that going to be difficult. The fact that the private sector is going after that market below $108,000, then in effect it appears as though you want it both ways. At least it seems that way.

Mr. REED. Senator, Fannie Mae can compete with us above $108,300 provided they compete under these same rules. If Fannie Mae does not have the Treasury backup and so forth and did not have an agency status which they have, we feel we could compete very effectively with Fannie Mae. Our securities should trade similarly with theirs under those conditions. We would welcome that opportunity.

Senator DODD. I understood you to say you intended to do it anyway and you realize that's an advantage you're competing for. Is that correct?

Mr. BEAL. Assuming S. 1821 and S. 1822 are passed.

Senator DODD. My last question, Mr. Pope—the reason I raise it is because your parent corporation which is my constituent is in an area where a mortgage of $108,000, unfortunately, is not excessively high at all. In fact, it would be low to what the median mortgage rate would be and there are other areas of the country obviously where those numbers change.

I wonder if having some sort of geographical formula to allow for some consideration of higher cost areas should be taken into consideration. Obviously, $108,000 across the board is a fairly reasonable or may be a reasonable figure, but in certain parts of the country it is not reasonable at all. Do you have any thoughts on that at all?

Mr. POPE. Senator, we are very mindful of the problems of your constituents, particularly as they relate to this particular issue. In a way, I guess it's very difficult for us to come to grips with the fact that the Congress is saying that people who can afford $115,000, $120,000 or whatever upper priced house are really low and moderate income Americans, that, in effect, need a subsidy of some kind or some type. It's hard to grasp that. Regardless of the geographic location in which a person chooses to live, if there were some increase in those limits—just to show you how narrow the current market is above the $108,000—as I think Mr. Beal stated, and our statistics would agree—that we are only dealing with 8 percent of the market and that if those limits were raised to $125,000, you would cut out 52 percent of that little market that's left to the private sector to try to develop. So we are very mindful of the problem, but when we look at it in the total perspective I guess we still feel that the interest of all parties would be best served by leaving those loan limits as they are currently structured.

Senator DODD. Thank you. My time has expired.

Thank you, Mr. Chairman.

Senator TOWER. Mr. Beal, Mr. Reed, Mr. Pope, thank you very much for some very helpful testimony that's contributed a great deal. We thank you.

Our next panel of witnesses are Mr. Stuart A. Davis, member, Realtors Legislative Committee, National Association of Realtors in St. Louis; and Mr. David C. Smith, vice president and secretary, National Association of Home Builders in Washington.

Mr. Davis, would you proceed? Let me say what I said to the other witnesses, that we must limit your oral presentations to 5 minutes. We will include in the record anything that you choose to submit and if you have a longer statement that you would like to submit for the record it will be incorporated in its entirety in the record. I'm sorry about the time constraints that militate against our having a longer presentation, but if you would confine it to 5 minutes we would be grateful.

STATEMENT OF STUART A. DAVIS, MEMBER, REALTORS LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS, ST. LOUIS, MO.

Mr. DAVIS. I will try, Mr. Chairman.

[The complete statement follows:]

STATEMENT
OF STUART A. DAVIS
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
before the
SENATE HOUSING SUBCOMMITTEE
of the
BANKING, HOUSING & URBAN AFFAIRS COMMITTEE

My name is Stuart A. Davis. I am a member of the Legislative Committee of the NATIONAL ASSOCIATION OF REALTORS® and a former member of the President's Commission on Housing. I am from St. Louis, Missouri.

On behalf of the more than 600,000 members of the NATIONAL ASSOCIATION OF REALTORS®, I appreciate the opportunity to present our views on the Secondary Mortgage Market Enhancement Act of 1983, S. 1821, and the Trusts for Investment in Mortgages Act, S. 1822.

The NATIONAL ASSOCIATION OF REALTORS® supports the conceptual goals of both secondary market proposals and applauds the leadership of this Committee for developing long-range legislation which will foster the growth of the secondary mortgage marketplace. The Association supports the goals of S. 1821, but also recognizes that the highly complex nature of securities warrants close scrutiny to guard the quality of mortgage-backed securities for the future.

The Need for Mortgage Credit in the 1980's

Mr. Chairman, one very important truth gleaned from our problems in the housing depression of the past few years is that adequate and affordable supplies of mortgage credit are essential for a healthy housing market. Recent experience makes a clear case that our current ability to meet housing credit needs is in question. Indeed, this Committee has consistently raised many of the proper questions to be examined if mortgage credit needs are to be met in the future. This country's mortgage credit requirements will be substantial for the rest of the decade, over 1.5 trillion dollars. In order to meet this growing challenge, the way mortgages have been traditionally financed will have to change.

For the past forty years we have had affordable mortgages originated and held profitably by depository institutions, primarily savings and loans, who derived their funds from inexpensive regulated savings accounts. However, this system is in a state of flux due to technological changes in the marketplace and today's economy. More and more mortgages are being sold by lenders who originate loans and then sell them in the form of mortgage-backed securities to investors in the secondary market. In 1982, approximately thirty percent of all loans originated by lenders were sold to traditional secondary market entities. By the end of the decade, over eighty percent of all mortgages will be financed by sales to investors in the secondary market -- historically active participants such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and new private sector players such as General Electric Corporation and Residential Funding Corporation.

S. 1821: The Secondary Mortgage Market Enhancement Act

In general, Mr. Chairman, the National Association supports the goals of this legislation. We believe, as do the bill's sponsors, that it is necessary to remove the existing legal and regulatory barriers which have stifled the growth and development of mortgage-backed securities.

The development of new secondary mortgage instruments that can compete with corporate securities, stocks, and other investments in the nation's capital markets will be the single most important factor in the ability of secondary markets to meet this country's housing credit needs.

Mortgage-backed securities enable investors unfamiliar with the business of mortgage lending to invest in familiar securities that, in fact, derive their income from the monthly payments of large "pools" of mortgages. Once mortgage-backed securities win the confidence of investors, mortgage credit will be able to compete in the capital markets.

The NATIONAL ASSOCIATION OF REALTORS® believes that S. 1821 will provide the foundation for investor acceptance of mortgages as competitive investments, and supports the nurturing and fostering of new private sector entrants as a means to meeting housing credit needs. However, we do not believe that this process should result in a diminished role for Freddie Mac and Fannie Mae. As such, the NATIONAL ASSOCIATION OF REALTORS® strongly urges this Committee to amend S. 1821 by providing for an increase in Freddie Mac/Fannie Mae mortgage limits in high cost areas. We would recommend against reporting this legislation without addressing this important issue.

To be sure, S. 1821 takes a much needed step forward in enhancing private sector involvement in this area and in improving the marketability of mortgage-backed securities. However, we will want to observe the future progress and development of private sector entities under the structure of S. 1821 and evaluate their ability to meet the needs of America's homebuying public. No evidence exists, at this time, that new private sector players will want to become involved in less profitable spheres of the housing market or that they will even remain in housing should other industries prove more profitable.

This "trial period," has already passed for Freddie Mac and Fannie Mae. These institutions have been successful in fulfilling this nation's public policy goals of housing support for all homeowners since their inception. Because Freddie Mae and Fannie Mae were chartered by the Congress with strong public policy goals rather than pure corporate goals, their continued participation as strong effective competitors in the mortgage market is essential during this "trial period" to ensure that all housing needs are met.

We believe that raising the mortgage limits for Freddie Mac and Fannie Mae in high cost areas would achieve this goal.

Currently, Fannie Mae and Freddie Mac may not purchase loans with balances greater than $108,300. We support an increase in this limit whereby Fannie Mae/Freddie Mac mortgage increases in HUD-designated high cost areas would be tied to the same percentage increases allowed under the FHA Section 203(b) mortgage insurance program. Just as in the 203(b) program, limits would increase by up to 33 1/3 percent.

Deregulation of the thrift industry has resulted in broadened asset and liability powers for thrifts, with less focus on home mortgage lending. Since savings and loans and other primary market lenders can now originate residential loans without regard to any dollar ceiling, Fannie Mae and Freddie Mac should be able to purchase the residential mortgages originated by these lenders.

Maximum efficiency in the housing finance system will ensure that an adequate volume of credit is available at competitive rates needed to sustain a housing recovery. Currently, mortgage markets are segmented between those mortgages that can be sold in volume in the secondary markets and those that cannot. As a result, homebuyers desiring conventional loans in high cost areas, second mortgages, or a variety of alternative mortgage instruments not accepted by the secondary market corporations, must pay a premium on their rates because of limited access to the secondary market. Loan limits prevent Fannie Mae and Freddie Mac from achieving their full potential in reducing the cost of mortgage funds to all home purchasers by competitively tapping capital market dollars.

Support to moderate income homebuyers will not be diluted by removal of the mortgage limits. For example, the average conventional mortgage purchased by Freddie Mac has been consistently below the statutory ceiling. Freddie Mac purchases mortgage loans, pools and sells them in the form of mortgage pass-through securities. Because of this financing mechanism, the corporation is not under any capacity constraints that would cause it to reduce its commitment to low and moderate income home purchasers if the loan ceiling is removed.

Equal access to the nationwide secondary market should be provided to parts of the country with a high cost of living. A home comparable to one costing $70,000 in Akron, Ohio costs $126,500 in Providence, Rhode Island; $135,000 in St. Paul, Minnesota; $165,000 in Stamford, Connecticut; and $253,000 in Orange County, California. Urban areas in particular are limited in their access to the secondary market. In 1982, nineteen SMSAs across the country had average home purchase prices above the Freddie Mac's mortgage ceiling (FHLBB Interest Rate Survey). As a result, the corporation serves states with lower average home prices to a greater extent than higher costs areas. Removal of the limitations would result in equal access to the secondary market among all states notwithstanding the wide differentials relating to average home purchase prices.

Title I - Securities Laws Amendments

Now, Mr. Chairman, I would like to discuss the specific provisions of Title I. It contains provisions which amend the securities laws by removing certain federal and state impediments to trading and investing in mortgage-backed securities (MBSs). These changes broaden the base for investors in MBSs and and thus will enable these securities to compete for and provide America's mortgage credit.

- Federal Exemptions: This measure expands a current securities registration exemption at the federal level to encompass promissory notes secured by second mortgages on real estate, including stock in cooperative housing units, as well as notes on mobile homes. Present law limits registration exemptions solely to first deed mortgages. Further, the proposed exemption is extended to certain types of issues and purchasers not presently receiving such consideration. These new exemptive areas are a recognition that the mortgage industry has developed to a point where market activity has entered areas not addressed by our securities laws. In simpler times the traditional and primary focus of the housing debt security was the promissory note secured by a first deed. We see a need for this broader exemption area so that it includes new forms of debt security in housing. We support it if it ultimately provides a forum for a greater acceptance of trading in MBSs. We urge, however, that proper and responsible scrutiny be given the highly volatile market that may possibly exist in second mortgages so that solid investor confidence is not lost at a time when MBSs need it the most.

- Broker Credit Extension: This legislation allows broker/dealers to extend credit to purchasers of mortgage-backed securities in the same manner and under the same terms as they now can for government agency issues. By allowing purchasers of MBSs to buy on the margin, this provision will accord more equitable treatment of privately issued mortgage-backed securities.

- Net Capital Requirements: This provision provides that the SEC accord the same treatment to brokers holding MBSs in its inventories as it does to brokers holding traditional securities. These inventories would include those newly exempted second mortgages and co-op notes. The net capital rule exists for investor protection and we support this provision. It will grant equal footing to MBSs so that brokers will find them an attractive security to trade.

- Investment by Federally Chartered Institutions/Underwriting by National Banks: This provision allows federally-chartered institutions -- banks, savings and loans, and credit unions -- to invest in mortgage securities subject to limitations imposed by their respective regulators. The present 15 percent portfolio limits on mortgage-backed securities will be removed. Specifically, Section 105 allows national banks to underwrite and sell private mortgage securities as they now do for housing revenue bonds and Ginnie Mae mortgage-backed securities.

The National Association supports the continued role of federally-chartered institutions in residential mortgage-related activities. Particularly now that thrifts have the ability to diversify their portfolios — often, moving away from housing, it is important that other institutions become more involved in mortgage finance. Indeed, national banks, which have historically not played a significant role in supplying mortgage credit, but which have tremendous assets to do so, can become active participants and fill the gap created by thrifts investing in alternative types of loans.

In conclusion, national banks are in a strong position to provide mortgage credit. They command large and multiple assets. At the end of 1982, there were 14,700 domestically chartered commerical banks with total assets of $1.8 trillion, and residential mortgages were $191 billion or 11 percent of these assets. The investment potential of these institutions is self-evident. We believe that the marketplace will benefit from this increased activity as long as adequate underwriting criteria are utilized and proper quality control is imposed on those personnel responsible for these activities.

- Federal Preemption: The bill removes additional restrictions presently applicable to securities trading in MBSs at the state level. It preempts state laws which prohibit state chartered entities from purchasing private issues of MBSs. Many "Blue Sky" laws prohibit state-regulated pension funds, insurance companies and other state institutions from buying these private issues, limiting purchases to federally guaranteed obligations. The authors of the bill note that MBSs were not even conceived of, much less considered, when many state securities laws were enacted. They urge that the time has come to remove investor limitations on these securities and that they should be considered as a workable and viable instrument in the marketplace. We note that the preemption applies only in the area of purchase and does not affect a state's requirements for registration of the security itself. It also does not interfere with a state's powers to enforce its antifraud laws in the interest of investor fairness and protection. Finally, we note that the states, within a two year period, may pass legislation overriding this preemeption if they deem the federal intrusion inappropriate. While we can appreciate the intent and purpose of this preemption concept, we presently are seeking a response from our national membership to determine the full impact of this provision among the various states.

In the absence of further concerns, expressed by REALTORS® in the field, we would accord tentative approval to this provision.

- Shelf Registration:

The provision would make permanent a temporary SEC rule whereby large issuers of securities are allowed flexibility in terms and timing of its offers to the public. The rule permits securities to be registered and then to be offered and sold on a "delayed or continuous basis," rather than under a rigid time schedule with no relevance to changing market conditions. This provision would be applicable to MBSs. We are aware that this rule has met with some success in the financial markets because issuers now can make judgments on the timing of offerings in conjunction with the fast changing market rates and conditions. This is also a cost saving measure and we support it. We must keep in mind, however, that the regulator must still be allowed ample opportunity to monitor these issuances so that the quality of the security remains unquestioned and the investor is still protected.

Title II - Federal Home Loan Mortgage Corporation and Federal National Mortgage Association Amendments

Mr. Chairman, I would now like to address the charter amendments for Fannie Mae and Freddie Mac contained in Title II.

These amendments include the following:

- Preferred Stock: This amendment requires Freddie Mac and Fannie Mae, in any issuance of preferred stock, to comply with New York Stock Exchange rules regarding voting rights for preferred stockholders.

Mr. Chairman, we understand that this amendment corrects a technical oversight, and we support its adoption.

- Subordinate Liens: This amendment will allow Freddie Mac to purchase or deal in junior liens, the proceeds of which do not have to be used only for home improvement or home purchase. Fannie Mae already has this authority. Mr. Chairman, market surveys indicate that homeowners who obtain loans secured by a junior lien do so for a variety of purposes, not limited to home repair. This authority will allow Freddie Mac to expand home mortgage financing options for homebuyers, and we support its adoption.
- State-insured Mortgages: This amendment to Freddie Mac's charter clarifies the definition of "conventional mortgage" so that mortgages insured by a state agency can be eligible for purchase by the Corporation. We support the partnership of Freddie Mac and state agencies to increase homeownership opportunities, and therefore, urge adoption of this amendment.
- Manufactured Home Authority: This amendment to Freddie Mac's charter clarifies the Corporation's manufactured home authority so that it can purchase loans secured by the manufactured home even if it is considered by a state to be personal or mixed property rather than real property. Mr. Chairman, we are aware that manufactured housing represents an affordable alternative for moderate and low income families who have been priced out of traditional, site-built housing. This provision will remove obstacles to the development of secondary market programs for these home purchases, and we support its adoption.

S. 1822: The Trusts for Investment in Mortgages Act of 1983

Mr. Chairman, we applaud the Committee leadership for introducing a TIMS proposal — for, so to speak, "getting the ball rolling" on this important subject.

The NATIONAL ASSOCIATION OF REALTORS® has been keenly interested in enactment of TIMS legislation. We, like many others, have been interested in the Administration's version of a TIMS legislative proposal, not only because of the tax implications, but because of the additional expertise that would come from such an effort. In the meanwhile, however, we support the use of S. 1822 as a vehicle for achieving the goals of TIMS.

The proposal introduced by the Committee Chairman and the Housing Subcommittee Chairman would make several amendments to the tax code to allow for the creation of a new private investment instrument with assets primarily in residential mortgages. The legislation would exempt a TIM from the tax code's grantor trust rules and treat the TIM and its shareholders as a partnership, with gains taxable only to the investor and not to the TIM.

S. 1822 would also allow a TIM trustee to manage cash flows from its mortgage-related investments to create multiple classes of securities with varying yields and maturities.

The NATIONAL ASSOCIATION OF REALTORS® is supportive of these amendments to the tax code and we believe they will remove many tax barriers that impede the development of this competitive instrument.

For example, the current "grantor" trust tax treatment has proven to be inflexible. A grantor trust is a "passive" tool and the trustee is limited in his/her ability to manage cash flows. S. 1822 would allow for an "active" management of the trust where the trustee is provided with more management flexibility. By allowing for multiple classes of securities, investors would be provided with "call protection," since prepayments could be applied toward another class of securities.

Mr. Chairman, we would like to address other features of S. 1822, which we have some concerns about.

S. 1822 specifically excludes Freddie Mac and Fannie Mae from being a TIM manager, director, trustee, or shareholder. The NATIONAL ASSOCIATION OF REALTORS® believes that this exclusion will place Fannie Mae and Freddie Mac at a competitive disadvantage with private sector issuers. We favor involvement by these two institutions because they continue to be viable, stable sources of housing credit. By excluding Freddie Mac, in particular, we also believe that the housing industry would be deprived of the Corporation's traditional innovative role -- a role that has provided the private sector with a successful working model of new programs. For example, Freddie Mac's recent design and introduction of a new mortgage instrument, the Collateralized Mortgage Obligation (CMO) is regarded by many to be the forerunner of TIMS. Furthermore, based on Freddie Mac's success in this area, Fannie Mae also plans to design a similar instrument. Mr. Chairman, the creative abilities and expertise that these two institutions maintain can only benefit the mortgage marketplace.

We are also concerned about the prohibition against TIM investment in multifamily mortgages. The NATIONAL ASSOCIATION OF REALTORS®, in historically supporting pension fund investment in multifamily mortgages, would at least conceptually, support investment by a TIM in these mortgages, provided they meet similar investment standards.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® also notes, with concern, that no qualification criteria exists in S. 1822 for trustees or managers of a TIM. We would urge that such criteria be included to ensure that trustees or managers are capable of administering a TIM and that the future credibility and quality of privately issued mortgage securities are not impaired.

Mr. Chairman, I thank the Committee for this opportunity and will be pleased to respond to your questions and comments.

Senator TOWER. Thank you, Mr. Davis, and your entire statement will be incorporated into the record.

Mr. Smith.

STATEMENT OF DAVID C. SMITH, VICE PRESIDENT AND SECRETARY, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

[The complete statement follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

before

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

on

September 21, 1983

Mr. Chairman and Members of the Committee:

My name is David Smith and I am a home builder and land developer from Frederick, Maryland. I am testifying as Vice President and Secretary of the National Association of Home Builders (NAHB). NAHB is a trade association of more than 112,000 members of the nation's homebuilding industry. I am pleased to testify on S. 1821, The Secondary Mortgage Market Enhancement Act of 1983. I will offer a few comments as well on the companion bill, S. 1822, The Trusts for Investment in Mortgages Act. Both bills would make important strides toward the expansion of the secondary mortgage market and the provision of credit for America's homebuyers.

HOUSING OUTLOOK

The housing recovery has received much attention lately as one of the bright spots in the economic picture. All indications show a substantial improvement in housing over last year. The improvement can be sustained if interest rates continue the decline of the last few weeks.

HOUSING PRODUCTION

New Housing production in 1982 totalled 1.07 million units, the lowest since 1946. Housing starts in the first 7 months of 1983 rose to a 1.7 million annual rate. We expect total production in 1983 to be 1.62 million units.

NEW HOME SALES

While 1982 was the worst year for new home sales since the Census Bureau began collecting statistics in 1963, sales of new homes in the first 7 months of 1983 were up 70% from the same period a year ago. The average seasonally adjusted sales rate for the first 7 months of 1983 was 628,000 units.

INTEREST RATES

Conventional mortgage interest rates have moved upward since May but declined slightly in recent weeks. They now average 13.75%. These rates are high by historical standards and the incomes needed to afford housing are still beyond the reach of many potential homeowners. The continuation of rates at current or higher levels poses a threat to the housing recovery.

UNEMPLOYMENT

Unemployment in the construction trades in August was 18.1%. The rate was almost twice as high as the overall rate of unemployment in the economy.

Despite the overall improvement in housing, some indicators pose troublesome signs about the continuation of the recovery. The level of interest rates in particular is making it difficult to qualify buyers to purchase homes.

The prospects for housing throughout the 1980s are difficult to predict because of the uncertainties of federal budget deficits and the volatility of interest rates. Nonetheless, the demand for housing will continue to rise. The population in the prime homebuying age group, ages 25 through 39, will rise from 51.7 million in 1980 to 63.5 million in 1990. These 11.8 million people represent a 13 percent increase in the population most likely to buy new housing. Household formations will also rise. Along with the absolute increase in the numbers of people desiring housing, there will be an increase in the formation of households of single individuals and single parents heading households. The average size of households declined from 3.11 in 1970 to 2.75 in 1980. To accommodate the demand for housing from 1983 through 1989, we estimate that housing production should average 1.65 to 1.75 million units.

To finance the housing demanded by the public for the rest of the decade, the Federal National Mortgage Association has estimated that $1.6 trillion in credit will be needed. Unfortunately, affordable housing credit is becoming harder to find. Rising interest rates, heavy government and corporate borrowing, and reduced regulation of financial institutions are combining to drive up the cost of financing a house.

SECONDARY MORTGAGE MARKET

Mortgage bankers, savings and loan associations and commercial banks originated 90.4% of the 1 to 4 family mortgages in 1982. Mortgage bankers resell their mortgages to investors. Savings and loans continued to be the single primary source of originations in 1983, originating 34% in the first quarter of 1983. But according to the Congressional Research Service, the S&L's actually reduced their holdings of such loans during that period through sales on the secondary market.

The secondary mortgage market is rapidly becoming the dominant source of funds for homebuyers. Excluding swaps, FNMA estimates that secondary mortgage market purchases since 1970 have averaged 41.1% of the 1-4 family dwelling mortgages originated. Since 1978 the average has jumped to 51.3%. By 1990 we estimate that two-thirds to three-fourths of all mortgages originated will be sold on the secondary mortgage market. The secondary mortgage market promises to provide the liquidity needed by mortgage originators to respond to the demand for housing credit.

Private entities will be needed to supplement the role of FNMA, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association in attracting investment in housing. FNMA holds 1 out of every 20 mortgages at present. FHLMC has committed to sell $76.6 billion in participation certificates in its mortgage-backed securities program as of September 9, 1983. GNMA has guaranteed $173 billion in mortgage-backed securities as of July 31, 1983. Despite their vigorous activity, these federally chartered agencies cannot meet the entire demand for mortgage credit in the future. Private entities will be necessary to meet the overall demand. These private entities should complement the activities of the federally charterd agencies and not replace them. The private entities cannot be expected to perform the countercyclical role of the federally chartered agencies nor can they be expected to provide the nationwide market that the agencies were chartered to provide. The federally chartered agencies are an integral part of governmental policies that have favored homeownership since World War II.

The mortgage-backed security will be the main vehicle to attract capital to housing in the future. It offers the capital investor advantages that are competitive with investment offerings by corporations and by governments. In June FHLMC readily placed a $1 billion offering of innovative Collateralized Mortgage Obligations. That offering is indicative of the potential volume and market acceptability of well-designed mortgage-backed securities.

Mortgage-backed securities (MBS), unfortunately, are subject to regulatory and legislative obstacles that hamper their competitiveness in the capital markets. The President's Commission on Housing recommended that "legal, regulatory, and tax impediments to the development of broad and active markets for conventional mortgage-backed securities should be eliminated." Regulatory agencies have made some of the changes recommended by the President's Commission on Housing. Other changes need to be made legislatively, which is the basis for the two bills offered by Chairman Garn and Chairman Tower. These bills would remove some of the obstacles in the securities and tax laws.

S. 1821, THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

The securities amendments in S. 1821 will make it easier to underwrite, deal in and invest in MBS. We support S. 1821 as a step toward the creation of fully viable private MBS. We would like to recommend a few changes to further improve the bill. First, we suggest the use of the term "residential mortgage-backed security" instead of "mortgage related payment bond." The former is the more commonly understood term and will ensure the coverage of the standard pass-through security. A definition of "residential mortgage-backed security" is attached to our written statement.

Second, the definition of "mortgage related payment bond" includes a requirement that the bonds be rated by a nationally recognized statistical rating organization. Since those organizations do not normally rate FNMA and FHLMC securities, the provision should be amended to exclude FNMA and FHLMC from the rating requirement.

Third, we recommend an additional paragraph to specifically preempt state blue sky laws as distinguished from state investment statutes. Neither type of statute should block the use of MBS.

Fourth, Section 106 should be amended to include FNMA and FHLMC in the preemption of state investment and blue sky laws. As written, the section preempts state statutes only for securities registered under the 1933 Securities Act. FNMA and FHLMC have statutory exemptions from SEC registration, so the state preemption would not apply to them under this Section. At present, state restrictions are preempted as to FHLMC, but that preemption expires in 1985. FNMA has no such Federal override, but has gained exemption from most state restrictions by state action. One federal preemption would help both FNMA and FHLMC maintain a national market.

We agree generally with the provisions in S. 1821 that expand the operations of the FHLMC. For example, the ability to deal in mortgages insured by state agencies will enhance the activity of FHLMC. We recommend additional amendments to help improve the operations of FNMA. Congress should eliminate the prior approval authority of the Department of Housing and Urban Development over FNMA's new programs and stock issuances. We also urge Congress to authorize FNMA to make loans on the security of mortgages. The change would enable FNMA to buy "builder bonds" issued by homebuilders. These pass-through bonds are collateralized by mortgages that the builder originates and holds. They have become the primary financing vehicle for the nation's largest builders and could become viable for groups of smaller builders, especially if FNMA could buy the bonds. Thirdly, we ask Congress to increase the loan-to-value ratio for multifamily loans bought by FNMA. That would help FNMA support the growing segment of the population housed in multifamily dwellings.

In addition to the above changes, we strongly recommend that the Subcommittee amend S. 1821 to increase the mortgage loan purchase limits for FNMA and FHLMC. This should be an immediate priority which should be dealt with this year as part of this legislation. Many high cost urban areas are underserved by FNMA and FHLMC because the price of housing for the middle income group has reached or exceeded the current purchase limits. For FNMA and FHLMC to continue their nationwide support of homeownership, we recommend that the limits be increased in high cost areas in a manner similar to that done for high cost areas under the Federal Housing Administration's single family insurance program. The secondary market is large enough to accommodate this increase in FNMA and FHLMC activity without stifling the growth of the private secondary market.

S. 1822, THE TRUSTS FOR INVESTMENT IN MORTGAGES ACT

We endorse the concept of Trusts for Investment in Mortgages as presented in S. 1822. The bill seeks to remove the tax code disadvantages to pooling privately issued mortgages. We urge you Mr. Chairman, to encourage rapid consideration of S. 1822 by the Finance Committee. There is one change which we believe is essential to the effectiveness of the TIMs concept. TIMs should be available to FNMA and FHLMC. Their participation is necessary to establish a trading benchmark and to ensure that efficient liquid markets develop. Their use of TIMs should ensure its success.

CONCLUSION

In sum, Mr. Chairman, with the changes we recommend we would support the enactment of S. 1821 and S. 1822. Both measures will help make private mortgage-backed securities more viable investments. They will attract more capital to housing. Coupled with other measures to reduce the cost of financing housing, they will help make homes more affordable. We welcome these modest measures that expand the national commitment to homeownership and rental housing. At the same time, Mr. Chairman, I am forced to express our dissatisfaction that the Senate has not yet acted on S. 1338, the Housing and Community Development Act of 1983. This legislation contains a number of important provisions which would assist HUD as well as homebuyers and renters in their effort to obtain decent shelter. We will be pleased to provide further information to assist the Subcommittee with its work on S. 1821. I will be glad to answer any questions about our views.

ATTACHMENT 1

Revise Section 101 of S. 1821 to read in part as follows:

Section 101. Section 4(5) of the Securities Act of 1933 is amended to read as follows:

(5)(B)...

"For the purpose of this paragraph, a residential mortgage-backed security means a certificate representing an undivided fractional interest in a mortgage investment pool, a participation in a mortgage investment pool, an undivided fractional interest in a debt instrument which is collateralized by the cash flow from a mortgage investment pool or residential mortgage-backed security, or a participation in a debt instrument collateralized by the cash flow from a mortgage investment pool or residential mortgage-backed security, but only if the mortgage investment pool or debt instrument is held in trust or under an agreement for the benefit of the security holders and is secured solely by, or represents solely interest in, residential mortgage loans described in 4(5)(A), property which had secured such residential mortgage loans and has been acquired by foreclosure, and undistributed cash. If privately issued, such a residential mortgage-backed security must be rated in one of the three highest rating categories by at lease one nationally recognized statistical rating organization."

Mr. **Smith**. Also, Mr. Chairman, with reference to that comment, I would welcome any suggestion that you might give me to take back to my board of directors in an important meeting which starts later on this week.

Senator **Tower**. Thank you, Mr. Smith.

Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

Let me just say that we are delighted to have both of you as witnesses. You both represent very important organizations that do a great job, and we welcome your testimony.

PURPOSES OF CREATING FNMA, FHLMC, AND GNMA

The most important national purposes for creating Fannie Mae and Freddie Mac and Ginnie Mae have been the following: To help insure an adequate supply of affordable home mortgage credit to all American families; to insure that affordable mortgage funds will be available for moderately priced houses; to help moderate cyclical situations in housing sales—and we certainly had some recent experience with that situation—and also to insure that mortgage funds will be available in all areas of the country.

I am wondering two things, and I would like you to respond to both.

Do you think the passage of that bill would significantly advance those objectives, and, second, are you confident that a totally private secondary mortgage market would serve those objectives as well or better than the current system that we have?

Obviously, parenthetically, you may feel that those aren't the objectives we ought to have any more. I don't know that you argued that, but if you start from the premise that those are still worthwhile national objectives then I would like your response to both those questions.

Mr. **Davis**. To answer your question, Senator, would the passage of this legislation enhance the goals that you have cited, this legislation does not embrace Fannie Mae and Freddie Mac as much as we would like it to. Therefore, this bill may not enhance the goals you recited.

Finally, with regard to the privatization issue, I think that our association philosophically agrees with the ultimate privatization of both agencies, but not until we have evaluated an appropriate transition process to be sure that the new private entries are, in fact, here to stay.

The old question is where were they when we really needed them in the last 3 years, and that is rhetorical. It serves no purpose except to make us very nervous—where they may be in the next credit crunch.

We ultimately see a reason for privatization, but not until we are very, very sure that a housing commitment remains. We need to know, for a fact, that in good times and bad, the private issuers will be with us.

Senator **Riegle**. Right. I just might say before Mr. Smith responds, what is your own best sense for the kind of timeframe that you think it is likely to take to make this orderly transition?

Mr. **Davis**. Don't pin me down, Senator, but I think a lot of us have looked at a time around 1990. Perhaps, that is more my target than any one else's.

Having served on the President's Commission on Housing, having heard the testimony and participated in considerable dialog and documentation, it seems possible that by 1990 we could look at the privatization of Fannie Mae and, certainly, of Freddie Mac.

Senator **Riegle**. Mr. Smith.

Mr. **Smith**. Certainly the passage of the legislation is favorable, and we want to see that. As far as the private market versus Fannie Mae and Freddie Mac, we certainly need both of them. This is not a time really to experiment and do away with programs that have been very successful in the past and start something new.

We are not opposed to the private market in any way, shape, or form, but right now we think that we have got a good system. If you want to improve it, add to it, that is fine, but let's not throw it out and start with a new system at a time when the rates are what they are today.

We are still having an awful lot of people being denied homeownership in this country because of the high interest rates. We want to see the market strengthened and improved, which hopefully would bring the rates down, though we are not opposed to the private market. We need both.

Senator **Riegle**. What kind of a timeframe would you envision to see an orderly transition?

Mr. **Smith**. That is a pretty tough question. I would like for our staff to respond to that. We will get back to you on that.

I would hate to say a date right at the moment because we go through these cycles, up and down, and we certainly don't want to get ourselves in a position like we are right now with the rates being very high.

Senator **Tower**. We would be delighted to hold the record open so you could respond or even elaborate on some of your oral responses in writing.

[Information subsequently furnished for the record follows:]

Mr. **Smith**. The time needed to change from the present secondary mortgage market to a completely private market is a matter of speculation. From our perspective a change to a completely private market may not be in the best interests of housing finance. For the foreseeable future, the private entities will not be capable of fulfilling certain roles played by the governmentally related entities. These latter provide volume, innovation, and a guaranteed presence in the market in all economic conditions. They also help reduce the cost of financing housing, thus carrying out the national commitment to homeownership. A completely private market will not necessarily help make housing more affordable. The private entities' participation in the secondary mortgage market should be fostered, but not yet with the view toward replacing the governmentally related entities.

Senator **Riegle**. Just one other quick thing. I know home builders have taken a real pounding over the last 2 or 3 years, and yet rates did come down over the last several months and we saw a pickup in housing starts, and it looks like the latest data of 2 or 3 days ago indicates that that may have continued at least in terms of building permits.

HOMEBUILDERS NERVOUS AS INTEREST RATES EDGE UPWARD

But I am nervous. Michigan builders are nervous. Rates have edged up again, and we have got Dr. Feldstein and Secretary Regan in sort of a hair-pulling contest as to whether deficits do or don't affect interest rates and whether we are likely to see rates going up further or staying up, and with Dr. Feldstein today quoted in the paper as saying he sees no reason for long-term rates to come down, and that is what we are talking about here, long-term rates, in terms of housing mortgages.

I am just wondering, give us a patient condition on the homebuilders across the country today after this wring-out period and then this burst of activity.

How are builders faring out there, and can we afford to sort of take the roller-coaster right down again any time soon without losing a lot more of them?

Mr. SMITH. We certainly cannot afford that, as you well know. We are delighted that the housing industry has picked up. I think that really demonstrates that there is demand for housing out there. But we recently have run a survey, and it shows that 26 percent of our builders are still buying mortgages down. Buydowns are probably one of the reasons that some builders are still operating.

And I would like to point out also that while we are talking about starts on one hand, that building permits are down on the other side. And you know it is one thing to start houses and it is something else to sell them.

So the situation right now—and we are certainly pleased with what is happening—leaves us very cautious. We are concerned about going through another cycle.

I feel we cannot withstand another cycle. If we have to go through another cycle, we are going to lose a lot more builders.

Senator RIEGLE. Well, that is my concern as well, that this last period we have been through has been so severe— I mean we lost a lot of people. You know, it has been a terrifically difficult period for realtors as well, and what I worry about if we go back into that kind of a negative period for a while, that some of those that survived the last situation may not have enough fat on their bones to get through another one if one comes soon here.

Mr. SMITH. No question.

Senator RIEGLE. My concern is I don't want to see a radical disruption of some of the mechanisms we have that continue to keep some lifeblood flowing out into the market for members of both your organizations as well as, of course, the home-buying public.

Well, I thank you for your testimony.

The chairman has had to step away for a minute. There may be other questions for the record for you.

Mr. DAVIS. One final comment, Senator, if I might.

Senator RIEGLE. Yes.

IMPACT OF BUDGET DEFICITS ON FUNDS AVAILABLE FOR HOUSING

Mr. **Davis**. As you know, the National Association of Realtors is extremely concerned about budget deficits and their ultimate impact on the capital markets and funds available for housing. I think from past experience that this legislation is one of the most important measures that we have seen in a long time. As this bill applies to mortgage finance, it opens up a marketplace that heretofore, if nothing else, by "mindset" has not attracted mortgage investors.

So we are delighted that you have taken an interest in this. We are very, very pleased to testify, and we will do everything we can to see that this bill goes through.

Mr. **Smith**. We feel the same way as far as the builders are concerned.

Senator **Riegle**. Thank you.

Senator **Tower**. Gentlemen, if I might just try to draw the bottom line here, the thrust of your testimony is this, that as long as adequate protection can be afforded for Fannie Mae and Freddie Mac you don't regard the entry of the private sector in the secondary mortgages as just a nice thing to have but really a welcome and desirable thing?

Mr. **Smith**. That is correct.

Mr. **Davis**. Absolutely.

Senator **Tower**. And you do support that concept?

Mr. **Smith**. Yes.

Mr. **Davis**. Yes.

Senator **Tower**. Thank you very much, gentlemen.

Mr. Thomas, Mr. Gourley, Mr. Simpson, Mr. Lange, Mr. Green.

Our last panel this morning consists of Mr. Eugene L. Thomas, the American Bankers Association, executive vice president of Arizona Bank, accompanied by Mr. Leland Tanner, first vice president of Indiana National; Mr. Willard Gourley, chairman of the Mortgage Bankers Association Legislative Committee, and president of the Northwestern Mortgage Corp. of Charlotte, N.C.; Mr. William A. Simpson, vice president of Mortgage Insurance Co. of America and CEO of Republic.

Gentlemen, we are glad to have you here this morning, and we will ask you to confine your oral presentations to 5 minutes, since we are operating under very severe time restraints, and you may enter anything you have for the record in complete statements, and if you could summarize those in 5 minutes we would be grateful.

I will first call on Mr. Thomas. I notice that North Carolina has an inordinate percentage of witnesses here today.

Mr. **Gourley**. All good friends.

Senator **Tower**. Mr. Thomas, would you proceed?

STATEMENT OF EUGENE L. THOMAS, THE AMERICAN BANKERS ASSOCIATION, EXECUTIVE VICE PRESIDENT OF ARIZONA BANK, ACCOMPANIED BY LELAND TANNER, FIRST VICE PRESIDENT OF INDIANA NATIONAL

Mr. **Thomas**. Thank you, Mr. Chairman.

I am Gene Thomas, executive vice president of the Arizona Bank of Phoenix, Ariz.

[The complete statements follow:]

TESTIMONY
OF THE
AMERICAN BANKERS ASSOCIATION

Mr. Chairman, I am Gene Thomas, Executive Vice President, Arizona Bank, Phoenix. Presently I serve as Vice Chairman of the Housing and Real Estate Finance Division of the American Bankers Association and I appear in that capacity. I am accompanied by Leland E. Tanner, First Vice President and Trust Officer, Indiana National Bank, Indianapolis, Indiana. As you are aware Mr. Chairman, the ABA is a national trade association whose members consist of more than 13,000 banks, more than 90 percent of the full service banks in the United States. We appreciate this opportunity to testify on S. 1821, the Secondary Mortgage Market Enhancement Act of 1983 and S. 1822 the Trust for Investment in Mortgage Act.

We feel that this is an opportune time to consider legislation dealing with housing and the secondary market and we applaud your Committee's recognition of this by holding these hearings. At this time, there is a shift away from the traditional sources of mortgage funds to a greater reliance on the general capital market and this interrelationship is likely to increase in the future. As a result, any positive or negative effects on the general capital markets also now influence the housing market in much the same way. The funding of large federal budget deficits and the role of the federal government in the allocation of credit are but two issues weighing heavily on the markets. From a commercial bank perspective, we would like to address some of these economic concerns and the effect they may have on the future of housing before commenting specifically on S. 1821 and S. 1822.

Commercial Banks and the Housing Market

Commercial banks participate in the housing market as one of a number of institutions that provide funding for housing the nation. We believe that the housing needs of the nation can best be filled by a freely competitive primary and secondary housing finance market. Although commercial banks are a major provider of housing finance they are not as completely deregulated as other providers, resulting in a less efficient market.

The primary mortgage market is served by commercial banks and other providers originating and holding mortgages. Through the first six months of 1983, banks originated over $17 billion in mortgage loans for 1-4 family nonfarm homes, over 20 percent of all originations. At the end of December 1982, commercial banks held $162.6 billion in residential mortgages with additional mortgages being held by bank trust departments. In regards to the secondary market, banks held $17.3 billion in debt securities of the three sponsored secondary market agencies—the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Banks continue to hold over 20 percent of the total outstanding debt issues of the FNMA. Additional bank participation in the secondary market is evidenced through the ownership of mortgage banking affiliates which originate loans for sale in the secondary market. Of the top 100 mortgage bankers, 46 are bank related.

Government spending and the allocation of credit

In recent years, the government has increased its presence in credit markets. This increased presence results from funding the huge federal budget deficit currently estimated in excess of $200 billion. In fact, the debt service of the federal debt for the current budget is equal to the total amount of the entire budget just twenty years ago. Our Association is concerned that the government presence in the debt markets is having an adverse effect on interest rates as well as crowding out capital for private sector borrowing. A diminished government presence in the capital markets will result in benefits to both the housing market and the economy in general.

The Economic Advisory Committee of the American Bankers Association, a group of chief economists from major banking institutions, has recommended that the deficit be reduced by decreasing government spending (statement attached). All sectors of expenditures should be candidates for reductions.

The government influences the credit market through a variety of agencies which issue debt guaranteed or sponsored by the government. The debt of these agencies has grown rapidly with the amount of funds raised under Federal auspices doubling from 1978 to 1982. Such agencies are also provided certain advantages not available to other players such as agency status for their debt obligations and exemptions from certain taxes. The effect of these advantages is to subsidize certain areas of the credit markets which receive a disproportional amount of credit while the unsubsidized areas will be at a disadvantage and receive a lower amount of credit than they would otherwise.

An example that bears out our fears is the evolution of the Cooperative Farm Credit System (CFCS). This has become the largest single lender to agriculture. Although we recognize the important role played by the CFCS in providing farm credit, it has entered traditional areas of banking while remaining free from the controls and requirements of the Federal Reserve System, the FDIC and the Comptroller of the Currency. This has impaired the competitive climate for agricultural lending. In view of this, we feel that it is important for Congress to carefully examine the programs which increase the government's role in the allocation of credit and work to decrease the role of those that are no longer needed or that have moved into competition with the private sector.

Housing and the secondary market

As we have mentioned, the ability to finance housing and the efficiency of the capital market are critically interrelated. Commercial banks, savings and loans, mortgage bankers and others must have the ability to sell mortgages in the secondary market. Because of deregulation through such legislation as the Garn-St Germain Act, commercial banks are now better able to compete and offer their customers more competitive products and services. However, banks must now pay market rates for their deposits. This has resulted in higher costs to banks for their lendable funds and a decreasing spread between the cost paid for deposits and the return realized from loans made, particularly, loan portfolios that contain older long-term fixed rate loans. In the process of maintaining our commitment to housing finance, we must, to a larger degree than in the past, utilize the opportunities which the secondary market offers. In other words, the management of our assets and liabilities will necessitate the need for a broader utilization of the secondary markets.

Through the creation of such institutions as Ginnie Mae, Fannie Mae, and Freddie Mac, the Congress has shown its support for encouraging participation in the secondary markets. These government mortgage lending institutions were created by Congress to expand the flow of funds from the financial market into housing and develop a well functioning secondary market. Fannie Mae and Freddie Mac were instrumental in developing and fostering the growth of the secondary market. In addition to purchasing mortgages, thus, assuring a constant supply of funds for housing, these institutions have brought a large degree of standardization to the marketplace and developed securities, backed by pools of mortgages, that allow investors to participate in the housing market.

The evolution and current status of Fannie Mae and Freddie Mac has been carefully examined by the President's Private Sector Survey on Cost Control. This Task Force was established on June 30, 1982 by President Reagan to, among other things, identify opportunities for increased efficiencies and reduced costs through executive action or federal legislation. The Task Force stated that..."the advantages enjoyed by the FNMA and FHLMC of agency status in placing debt and in not being disadvantaged in the issuance of mortgage-related securities act as powerful disincentives for well-capitalized private sector entities to compete in the mortgage market." The Task Force concluded that Freddie Mac acts as a mortgage company and should be taxed as one. It also found that both Fannie Mae and Freddie Mac would be willing to give up the special advantages of agency status if they could be reasonably assured of prospering in such an environment. Additionally, this finding included a recommendation that a fee be charged for the use of the government benefit these organizations currently enjoy.

Mr. Chairman, it is important for the Congress to consider the findings of this report in as much as this Committee is currently examining the secondary mortgage market and the role of the government sponsored enterprises in that market. The secondary market is now a large market with broad based support. Private entities such as the Residential Funding Corporation and the General Electric Credit Corporation are now active participants in the secondary mortgage market and have added to the scope of the secondary mortgage market. However, these private entrants operate mainly in areas that are not open to one of the government agencies. This is because the private entrants are unable to compete with the Federal and quasi-Federal entities which have the ability to raise funds at a lower cost due to their agency status. Thus, although the private firms can participate to some degree in the market, they are able to do so only at a competitive disadvantage.

Others also agree that an examination of Fannie Mae and Freddie Mac is needed. In introducing S. 1821 and S. 1822, Mr. Chairman, you mentioned that there was a title missing concerning the role of FHLMC and FNMA in the financial markets that was still under study which would refocus the role of each. The need for this refocus has also been mentioned by members of both organizations. Mr. Thygerson, President of FHLMC, in testimony on March 10, 1983 before this Committee, stated that he looked to Congress to provide direction on the issues of broader powers for his agency. Mr. Maxwell, Chairman of FNMA, in testimony that same day, also stated that the question of how much more private FNMA should be is one that should be addressed. We would like to add our voice to this message. We feel that the role of both organizations should be refocused and their status clarified. If they are to serve as a means of subsidizing the housing sector, then the subsidies should be explicitly recognized and legislated.

There have been various proposals set forth to accomplish this goal. In your introductory remarks to S. 1821 and S. 1822, Mr. Chairman, you mentioned three specific options — option 1 would entail the merger of FNMA and FHLMC, option 2 would leave FNMA intact but would transfer ownership of FHLMC to private status, and option 3 would leave both corporations essentially intact with an understanding no additional asset powers would be obtained by either.

At the present time we would support option 3, including an increase in the mortgage purchase limits for FNMA and FHLMC along the lines of the FHA 203(b) program for HUD high cost areas. While advocating the choice of option 3, however, we encourage Congress to move in the direction of providing competitive balance between FNMA and FHLMC and all other private sector entities desiring to compete in the secondary mortgage markets.

It is with in the context of these thoughts and observations on the mortgage markets and the role of government in the credit market that we comment on the bills S. 1821 and S. 1822. I would like now to turn to Mr. Tanner who will comment on these specific proposals.

S. 1821 - Secondary Mortgage Market Enhancement Act

S. 1821, the Secondary Mortgage Market Enhancement Act of 1983 enhances the marketability of the securities used in the secondary mortgage market and contains some technical changes to the FHLMC and FNMA charter Act. Title I updates many of the laws relating to mortgage related securities because current securities laws and regulations do not consider their special characteristics. The changes embodied in Title I will remove many of these impediments and will enhance the marketability and desireability of these instruments. Title II contains technical amendments which we deem appropriate and also support.

S. 1822 - Trust for Investments In Mortgages Act

As stated earlier, the ongoing deregulation of financial institutions has increased the need for mortgage lenders to rely on the secondary market. The importance of the secondary market will increase as deregulation proceeds and the role of depository institutions changes. To the extent market participants are free to create new and attractive mortgage-related securities, as would be permitted by S. 1822, the Trust for Investments in Mortgage Act, the flow of capital from investor pools of funds to homeowners would be facilitated.

The TIMs concept is a collection of proposed statutory and regulatory changes designed to remove current legal impediments, and encourage the broad acceptance of, new and improved forms of conventional mortgage-backed securities. In essence, the TIM would be allowed to manage cash flows from its mortgage related investments to create multiple classes of securities with different maturities and yields, with gains taxable to the investor and not the TIM.

Currently, many potential suppliers of funds to the housing market are inhibited by regulations that essentially limit purchase of instruments backed by mortgages to potential participants including insurance companies, pension funds and bank trust departments. The most significant restraints on development of more creative mortgage-backed securities are contained in the securities laws, ERISA and the tax laws. Certain regulations of the Federal Reserve System and the other banking regulatory agencies as well as a variety of state laws also need change. Several recent efforts to alleviate the regulatory burden are encouraging. For example, the SEC has expedited the process for registration of mortgage-related securities by allowing blind pool registration. Now a pool's prospectus need only describe the mortgage in generic terms, while actual pool data may be provided to pool investors at a later date. Another change relates to the fact that the Federal Reserve now permits conventional mortgage-backed securities to be used as collateral for margin credit with securities dealers. Further, the Department of Labor has granted exemptions which address the problems of ERISA. Much has been done but much more is needed.

The most significant obstacle remaining is the Internal Revenue Code which imposes double taxation on conventional mortgage-backed pass-through securities — at both the pool level and investor level. In order for a pass-through pool to avoid this double taxation, it must qualify as a grantor trust. However, as interpreted by the IRS, the grantor trust is extremely inflexible, requiring that the security closely resemble the characteristics of the pool of underlying mortgages. Further, the grantor trust restricts the trustee from actively managing the assets of the trust, therefore, the trustee has little ability to manage the cash flows of the pool. Without active management, the pool is unable to provide protection from mortgage prepayment, commonly referred to as call protection, for the investors, nor would it be able to insulate itself in a rising interest rate environment.

Today mortgage pass-through securities cannot compete with corporate bonds because the characteristics which make bonds attractive to bank trust departments, pension funds and others — liquidity, semiannual payment of interest, predictable maturity schedule, safety and call protection — are not necessarily present in a mortgage-backed security. If one can make mortgage-backed securities more competive with corporate bonds, then more funds might be attracted to the housing market. S. 1822 will resolve the tax problems and will permit greater flexibility in the development of new types of mortgage-backed securities. By creating a new form of flow-through entity for mortgage securities which allow for call protection and for multiple classes of securities, additional capital may be attracted to this market.

I would now like to turn specifically to the Section of S. 1822 dealing with the ineligiblity of FNMA and FHLMC to participate in the TIMs program. As has been mentioned, both of these quasi-government institutions along with GNMA have been effective in providing innovations in the secondary market which has facilitated the growth of the mortgage finance industry. These organizations should be commended for their fine contributions. Our concern, which we emphasized last March before your Committee and again today, lies in policies which may result in deviations from the pro-competitive environment and which would stifle the development of "private conduits", the new entrants in this market. These new players, the private sector players, are at a competitive disadvantage because, as previously noted, they do not enjoy similar benefits accruing to the government or quasi-government organizations. With this in mind, we urge Congress to carefully examine their future structure and relationship to the government. Our Association would support Fannie Mae's and Freddie Mac's participation in a TIMs program provided there is an acceptable, agreeable and appropriate phase out of the advantages they now have. We would continue to urge you, Mr. Chairman, and the members of this body to continue to play an active role in assuring the maintenance of a pro-competitive environment. Both bills, S. 1821 and S. 1822 make a contribution toward this effort.

Appendix I

American Bankers Association
Statement on
Federal Budget Policy
Economic Advisory Committee
September, 1983

The Administration has based its economic program on four main elements: reductions in the rate of growth of government spending and taxes, monetary policy designed to reduce inflation and a program to reduce the regulatory burden on businesses and individuals. The first two elements directly influence the budget. Reductions in taxes were carried out through the Economic Recovery Tax Act in 1981. However, some of the reductions were eliminated in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA). Expenditure reductions were accomplished in the 1983 budget. However the deficits, including off budget items, are estimated to be approximately $200 billion in FY 1984 and FY 1985 and over $150 billion in FY 1986 and FY 1987 according to the President's proposed budget.

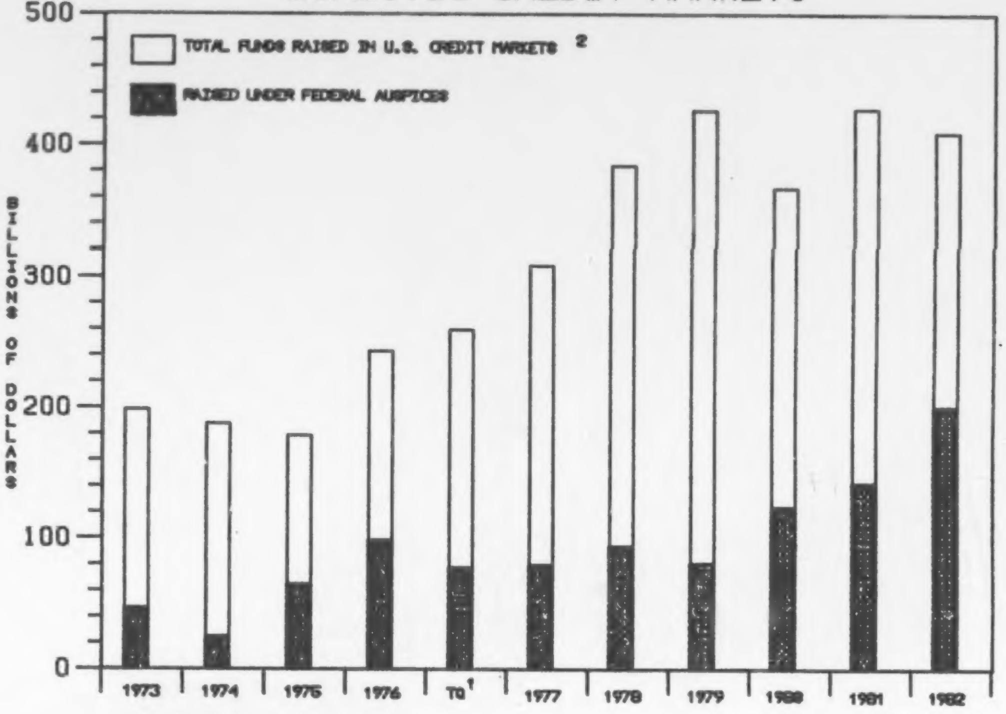
Our Committee feels that the prospective deficits will result in real interest rates higher than they would have been at lower levels of deficits. These high deficits and increased rates will have adverse effects on the economy which are meaningful and worthy of attention.

The Committee believes significant reductions in the growth of spending should be an urgent government priority. All sectors of expenditures should be candidates for reduction. Since defense and direct benefit payments for individuals make up 71% of government expenditures in 1984 according to the recommended budget, these areas must be examined closely.

The Committee is skeptical of the benefits of advocating tax increases. Tax increases may have negative impacts on the long run health of the economy and seem to do little to decrease deficits. In particular, our fear is that tax increases, ostensibly to reduce deficits, may shift the political focus away from the need to reduce spending and, in the end, not achieve any real reduction in the deficit. TEFRA was enacted to decrease budget deficits. After its enactment the estimated budget deficits for the next two years are still about $200 billion. Its actual effect on the deficit is small and it has had a negative impact on the prospects for long term growth of the economy by decreasing the incentive to invest.

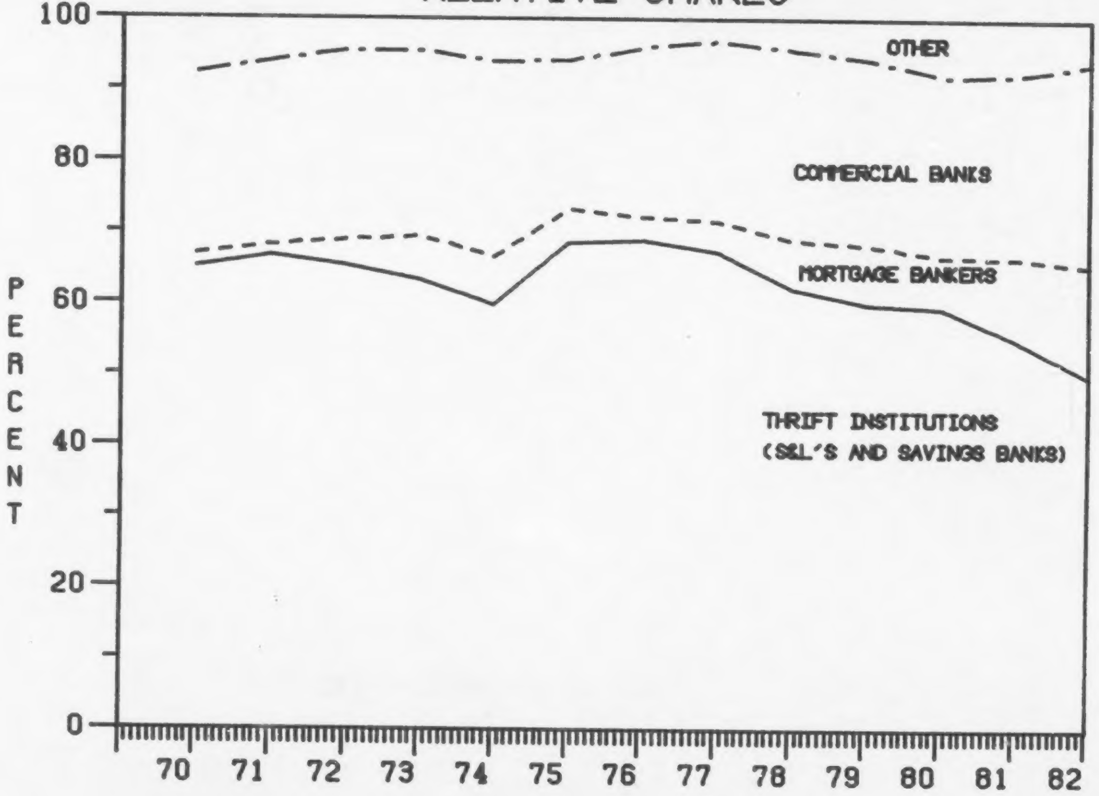
A most important need for both businesses and individuals is to have consistent tax policies over time so as to facilitate rational financial planning and reduced deficits. The tax system should be structured so as to maximize the amount of funds going to productive investment in the private sector. A healthy, growing private sector of the economy can best be facilitated by significant reductions in government spending so as to free up real resources for private investment.

FEDERAL PARTICIPATION
IN
DOMESTIC CREDIT MARKETS

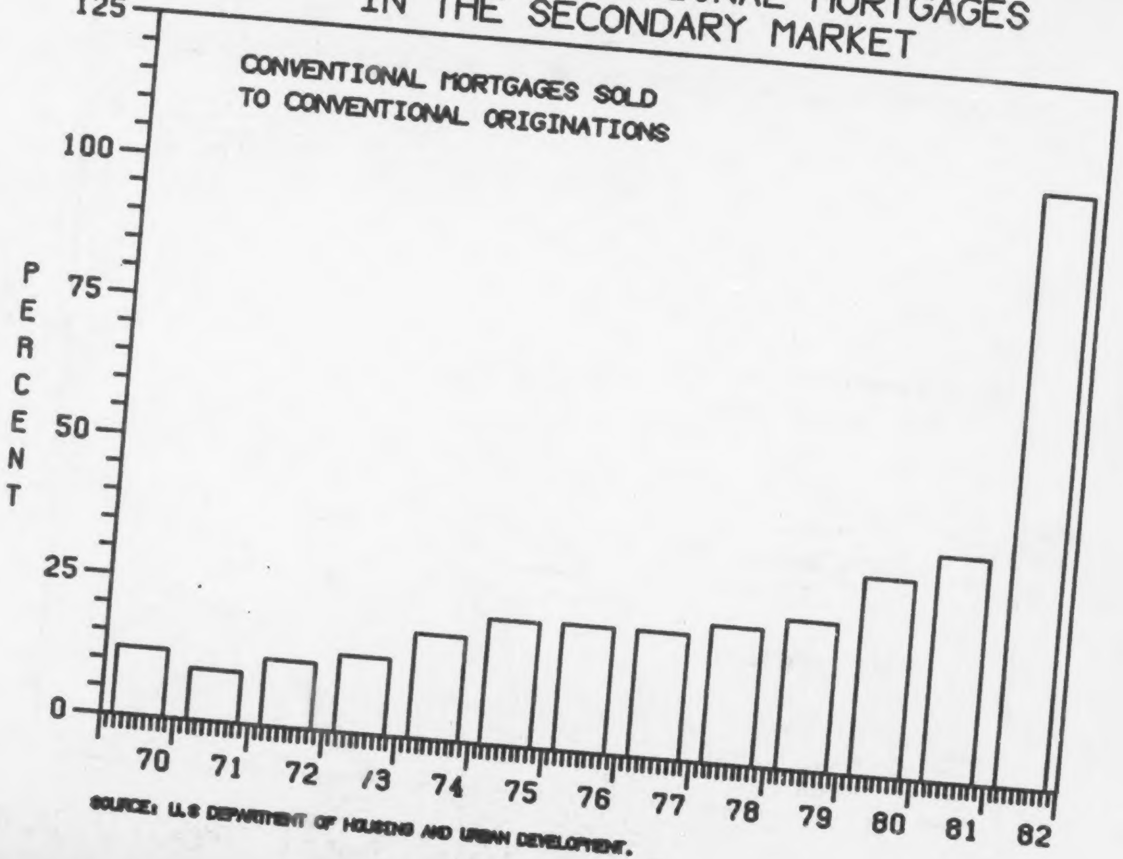


1. TRANSITION QUARTER
2. NON FINANCIAL SECTOR, EXCLUDING EQUITIES.
SOURCE: BUDGET OF THE UNITED STATES

CONVENTIONAL 1-4 FAMILY MORTGAGE ORIGINATIONS RELATIVE SHARES



SOURCE: U.S DEPARTMENT OF HOUSING & URBAN DEVELOPMENT.



GROWTH OF CONVENTIONAL MORTGAGES IN THE SECONDARY MARKET

CONVENTIONAL MORTGAGES SOLD TO CONVENTIONAL ORIGINATIONS

SOURCE: U.S DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT.

Senator TOWER. Thank you.
Mr. Gourley.

STATEMENT OF WILLARD GOURLEY, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION LEGISLATIVE COMMITTEE, PRESIDENT, NORTHWESTERN MORTGAGE CORP., CHARLOTTE, N.C.

[The complete statement follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

WILLARD GOURLEY, JR.
PRESIDENT

NORTHWESTERN MORTGAGE CORPORATION
CHARLOTTE, NORTH CAROLINA

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

S 1821, "The Secondary Mortgage Market Enhancement Act of 1983," and
S 1822, a bill amending the Internal Revenue Code to authorize Trusts for Investment in Mortgages

September 21, 1983

Mr. Chairman and Members of the Subcommittee, my name is Willard Gourley. I am President of Northwestern Mortgage Corporation, located in Charlotte, North Carolina. I also serve as Chairman of the Legislative Committee of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking and real estate finance industries. Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, and Sharon M. Canavan, MBA's Associate Legislative Counsel.

We appreciate the opportunity to appear before you today to discuss the recently introduced bills, S 1821, the "Secondary Mortgage Market Enhancement Act of 1983", and S 1822, which amends the Internal Revenue Code to authorize Trusts for Investment in Mortgages (TIMs). MBA strongly supports the concepts embraced in these legislative proposals. Passage of these legislative proposals would provide a significant impetus to the development of conventional mortgage-backed security (CMBS) markets.

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*The Mortgage Bankers Assocation of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D,C. 20005; Telephone: (202) 861-6500

MBA is deeply concerned, however, that S 1822 fails to include the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) in the benefits accorded by the TIMs proposal. MBA also strongly supports the inclusion of a provision providing for an increase in the FNMA and FHLMC mortgage purchase limits in high-cost areas.

Mortgage banking is a function that relies exclusively on the sale of newly originated mortgages to investors. As such, the secondary market is critically important to the operations of a mortgage banker. Approximately 65 percent of the loans originated in 1982 were sold into the secondary market by mortgage bankers and other lenders. Investors are increasingly interested in purchasing mortgage-backed securities rather than individual loans, because of the increased liquidity of the securitized instrument. In light of these factors, mortgage bankers are vitally interested in the evolution of the mortgage securities market, and the proposals embodied in this legislation.

These initiatives, if passed, would provide a substantial boost to the development of CMBS markets by easing Securities and Exchange Commission (SEC) requirements and state-imposed regulations and impediments that diminish or effectively preclude investor interest in CMBS-type instruments. The TIMs proposal would further broaden the base of investors interested in mortgage products by allowing active management of CMBS pools in order to permit reinvestment and by authorizing multiple classes of securities to meet varying investor needs as to yield and term.

THE EVOLUTION OF THE SECONDARY MORTGAGE MARKET

The past few years have produced a revolution in the secondary mortgage market. While a decade ago, traditional investors, such as thrift institutions, were the principal holders of residential mortgages, the development of mortgage-backed security instruments during the 1970s broadened the types of investors interested in holding mortgages. During the past 15 years, the chief actors responsible for developing MBS products and establishing their success were the Federal and federally-related agencies—the Government National Mortgage Association (GNMA), FNMA, and FHLMC. Their combined efforts in experimenting with various types of mortgage-backed securities established the acceptance of these instruments by Wall Street and, thus, expanded the universe of investors in mortgage products.

At the same time this growing acceptance of MBS issuances was occurring, another significant phenomenon was taking place. Deregulation was forcing financial institutions to attain a more perfect match between assets and liabilities as these institutions were permitted to pay market rates to depositors and forced to reappraise the types of assets and yields required to maintain profitability. In order to offset the higher rates paid to depositors, institutions must now place greater emphasis on portfolio investments that adjust flexibly to changes in market rates of interest, so that asset yields can rise and fall more closely in line with the rates paid to depositors. Alternatively, these depository institutions seek assets that are more liquid or shorter-term in nature and, therefore, may be bought and sold more easily.

Deregulation has dramatically accelerated the development of the secondary market. From 1970 through 1978, the percentage of funds for new mortgages raised in the secondary markets through loan sales to investors averaged 35 percent. Since then, the secondary market has become even more important. In 1982, the percentage of new mortgage money raised through loan sales reached 66.7 percent. These figures exclude the swaps of seasoned loans for mortgage-backed securities by thrift institutions, which are designed to ease their financial difficulties. Furthermore, potential mortgage demand in the 1980s will match or exceed the strong pace of the 1970s. However, affordability remains a significant problem at present and foreseeable levels of interest rates.

These combined factors—the changing role of traditional mortgage investors with the concommitant trend of reliance on the secondary mortgage market as an increasingly dominant source of mortgage credit, as well as the strong, continuing, potential demand for mortgage credit—mandate that new sources of investment funds be developed, if mortgage credit is to become more affordable and attainable for the majority of American families seeking homeownership.

THE SECONDARY MORTGAGE MARKET INITIATIVES

In this testimony, we will discuss the concepts and thrusts of S 1821 and S 1822, and MBA's strong support for them. In a separate and later communication with the Subcommittee, we will furnish our detailed analyses of the two bills and suggested amendments to the various provisions, which we believe would make the legislation more effective and workable. For instance, the section-by-section analysis of S 1821 provides for the preemption of state blue sky laws that restrict the issuance of CMBSs, however, the legislative language does not contain such a provision. Our detailed comments will deal similarly with other provisions that we believe will need change or clarification.

S 1821 contains a variety of provisions that would enhance the development of CMBS issues. Title I would expand the types of mortgages that are eligible for MBS treatment beyond first liens into mortgages secured by second liens, manufactured housing, and cooperatives. The types of securities would also be expanded to cover mortgage-related payment bonds, as well as notes secured by mortgages. SEC shelf registration would be made permanent and would be expanded to include mortgagees approved by the Department of Housing and Urban Development (HUD), and the minimum transaction amount of $250,000 would not have to include a 'cushion' for prepayments. The legislation seeks to put CMBSs on the same footing as Government-backed securities by preempting state blue sky, legal investment, and investment grade requirements, by amending SEC net capital requirements for broker-dealers, and by allowing broker-dealers to extend credit for CMBS purchases on the same basis as they are currently allowed for Government-backed securities. National banks would be authorized to underwrite and deal in "investment-grade" CMBSs, and federally chartered institutions would be subject only to rules imposed by their respective regulators regarding investment in CMBSs.

Title II clarifies that FNMA and FHLMC, in issuing preferred stock, must comply with New York Stock Exchange procedures. MBA strongly supports the provisions in Title II that expand FHLMC's authority to include purchases of junior liens and manufactured housing, and that clarify FHLMC's authority to purchase conventional mortgages insured by state agencies. Finally, the bill makes clear that FHLMC does not have the authority to guarantee the MBS issuances of other entities.

S 1822 authorizes TIMs as a method of setting up actively managed CMBSs with certain tax advantages beyond those accorded grantor-trust type MBSs. The TIMs proposal removes tax liability at the pool level for CMBSs that are set up under specified guidelines. FNMA and FHLMC are specifically excluded from participating in the advantages offered by TIMs. The proposal authorizes multiple classes of securities that may be issued under TIMs, which would allow investors to receive different terms or yields. This is similar to the attractive investment incentives available under the newly introduced FHLMC Collateralized Mortgage Obligation, which allows investors to stipulate varying terms for their holdings. That offering has been exceedingly successful, and indicates that investors with the need for investments with more certain terms are attracted to instruments that can provide this benefit.

The TIMs proposal also allows the pool manager to disburse proceeds from a mortgage prepayment to investors or to reinvest those proceeds in replacement mortgages. S 1822 authorizes both first and second mortgages to be placed in TIMS eligible pools, so long as they are secured by a single-family, principal residence, including cooperatives. The mortgage can be to acquire or to improve a home. Finally, where proceeds from a prepayment, foreclosure payoff, retirement, or renegotiation of a mortgage need to be reinvested, the TIMs manager may make short-term investments for less than 180 days, so long as the proceeds from the short-term investments are reinvested in eligible mortgage assets.

MBA supports the thrust of S 1821 and S 1822 as a means of expanding the universe of investors who are willing to purchase mortgage products that can be fashioned to accommodate their investment needs. Both bills would address this need by easing securities, regulatory, and tax impediments to issuing mortgage securities and thus making CMBS issuances more attractive to investors.

ENHANCEMENT OF THE SECONDARY MORTGAGE MARKET

MBA has long championed the development of CMBSs and has worked hard to ensure that mortgage securities could be traded on an equal basis with corporate securities. Development of private issues of CMBSs has been difficult and their strong entry into mortgage investment markets has been impeded because of securities and tax restraints—both at the state and Federal levels. These impediments have hamstrung the mortgage market and have made it difficult for mortgage products to be sold on a competitive basis with other debt instruments. Removal of these roadblocks would further expand the universe of mortgage finance participants and would attract new types of investors. This will increase the supply of mortgage credit and hopefully, will help to improve the adequacy of sources of affordable mortgage funds.

Historically, GNMA, FNMA, and FHLMC have led the development of mortgage-backed securities. Although a few private CMBS issues were floated in the 1970s, they were issued on a one-time basis for the most part and did not make any significant inroads on the market. While it is important to encourage these private issuers, MBA thinks it is extremely unwise to exclude FNMA and FHLMC from the opportunities offered by the proposed legislative initiatives. MBA also objects to the stated bias against FNMA and FHLMC, particularly, as these organizations have performed an invaluable service in providing adequate supplies of affordable mortgage credit to American consumers under the umbrella of Federal Government sponsorship. We can find no evidence that the Federal presence in the marketplace, as represented by GNMA, FNMA, or FHLMC, drives up interest rates.

With potential home mortgage credit demand at historically high levels and the increased reliance on the secondary market, MBA believes that the emphasis should be on enlarging both general sources of mortgage credit—private and Government-related—rather than shrinking the role of Government and Government-related agencies on the untested assumption that private institutions could immediately pick up the slack.

Until an analysis of the level of mortgage demand and the ability of the private market to fulfill that need has been conducted, we believe that any discussion of a transfer of reliance from the Government-related to the private market is premature. Even with the active support of the Government-related mortgage institutions, this Nation still faces mortgage rates that are historically high.

Any dismantling of the Government-related mortgage markets, now or in the near-term future, will only exacerbate the problems of affordability. Affordability and the role of the Government in ensuring adequate support for housing are the issues that must be thoroughly studied before rushing headlong into privatization. To date, to our knowledge, no such studies have been undertaken.

Furthermore, it is clear that private and Government-backed markets can coexist and compete with one another, as evidenced by the strength of the conventional mortgage insurance industry and its phenomenal growth during the 1970s despite the presence of Federal Housing Administration (FHA) mortgage insurance programs and the Veterans Administration (VA) guaranty program. Rather, these programs served to prove the actuarial viability of mortgage insurance, and amortized, long-term mortgages. Furthermore, FNMA and FHLMC, the principal secondary markets for privately insured conventional loans, provided standardization, which is extremely beneficial to the evolution and development of these types of mortgage instruments.

The primary argument being offered to substantiate the exclusion of FNMA and FHLMC from the benefits of S 1822 is that their presence will overwhelm that of private issuers. While there was a substantial market preference when MBS products were at an experimental state in the 1970s, when the perceived Government backing increased investor acceptance of these new products, this is simply not the situation today. The investment market is well-acquainted with MBS issues, as these products are tested and accepted by a wide variety of investors. Although the TIMSs proposal will alter the present form of MBS offerings somewhat, its chief goal will be to build upon the current types of offerings by reducing the investment disadvantages and the regulatory burdens of making these offerings.

Furthermore, unlike the private companies seeking to compete for CMBS markets, FNMA and FHLMC, still must fulfill their mandated public purpose goals. The presence of FNMA and FHLMC has not impeded the advance of private entities into the secondary market arena as much as the restrictions imposed by Government regulations. Once these impediments are removed, all competitors can strive against one another to deliver the product that meets the mortgage credit needs of a variety of consumers with different affordability requirements. FNMA and FHLMC should not be excluded from the markets they have worked on diligently to develop. The competitive edge they bring to the marketplace clearly works to the consumer's advantage.

Primarily, the issue boils down to one of timing. With the presence of such a high level of demand and the current affordability crisis, it appears to us that now is the time to add more actors to the mortgage marketplace, rather than the time to engage in an experiment to test the ability of private entities to replace Government-related entities in vital new markets.

The tremendous prospective demand for residential mortgage credit in this country has drawn the attention of many financial and industrial giants in recent years. Indeed, quite a few have already begun to establish market presences. It is MBA's belief that lower interest rates, more than any other factor, are the key to spurring additional private entrants actively into the marketplace. So long as mortgage rates are affordable and demand is present, the market will support competition among a large number of secondary market operations, because volume is the key to success in those markets. The inclusion of the widest variety of players in all mortgage markets will best serve the needs of consumers, who could choose from the widest variety of competitively priced products.

In fact, MBA believes that the inclusion of FNMA and FHLMC in TIMs would serve to propel the development of these markets, rather than inhibit private entries. The passage of these initiatives will introduce a new era in mortgage finance, similar to the early 1970s. The Federally sponsored instrumentalities will serve as a catalyst to these developing markets, as their presence would provide the standardization and volume that is necessary for CMBSs to attract investor interest. Those two factors are necessary to ensure that the products offered will be liquid and marketable. Furthermore, the participation of FNMA and FHLMC in all geographic markets and during all economic cycles will add much-needed stability to the marketplace and, thus, will serve as a continuing presence that investors may use as a benchmark against which to judge privately backed issuances. This stability will still allow experimental and custom-tailored CMBSs to be marketed successfully. But the market will be able to judge offerings against a standardized version.

During the initial development of CMBS issuances (and also Adjustable Rate Mortgages and other alternative mortgage forms in the primary mortgage markets), FNMA and

FHLMC played a crucial role in standardizing those instruments. Furthermore, marketability is often tied to the concept of a standardized, accepted instrument. For example, the Employee Retirement Income Security Act (ERISA) places a great deal of emphasis upon market acceptance and ties that concept to Government-type securities. The stabilizing presence of FNMA and FHLMC in the TIMs market would underscore the acceptability of the instruments. An alternative would be to define more closely the types of eligible instruments to achieve the goal of standardization. This, however, could stymie creative approaches or issues that are closely tailored to meet certain regional or local market needs.

The importance of standardization is that investors are most attracted to instruments that have large, liquid markets, so that the value of such a holding can be readily determined, and so that the instruments may be readily bought and sold. Inclusion of FNMA and FHLMC in TIMs will ensure the creation of a large, liquid market fairly quickly. That will benefit all participants—consumers, lenders, issuers, and investors. At the same time that MBA believes that S 1822 should include FNMA and FHLMC in its benefits, we are pleased that S 1821, with its emphasis on deregulating securities impediments, will place private entities on par with the federally sponsored agencies in issuing CMBSs. The expansion of shelf registration to second liens and purchases of cooperative and manufactured housing loans will expand the ability of private entities to compete head-on with FNMA and FHLMC, as will the preemptions for inhibitory state laws. MBA urges that whenever FNMA and FHLMC are allowed to expand their operations such benefits should likewise be extended to their competitors, if possible.

INCREASE IN THE MORTGAGE PURCHASE LIMITS FOR FNMA AND FHLMC

The failure to include a high-cost increase in the applicable mortgage purchase limits for FNMA and FHLMC (similar to that contained in HR 3420) should be corrected. MBA strongly urges the Committee to give serious consideration to the inclusion of a high-cost area increase in order to recognize the regional disparities that exist in housing costs. Although the purchase limit is adjusted annually, its relationship to housing prices will remain relatively constant. The current limit of $108,300 effectively excludes many potential FNMA and FHLMC purchases in a significant number of high-cost areas.

The effect of this discrimination is visited upon potential homebuyers in these areas in the form of generally higher interest rates or more restrictive loan terms. Many homebuyers are puzzled by the magic cutoff point of $108,300 in their efforts to secure affordable financing. The simple answer to their bewilderment is that they, as homebuyers above that point, are excluded from the benefit of participating in a highly efficient sector of the extremely competitive capital markets, via the secondary mortgage market programs offered by FNMA and FHLMC. This exclusion most often translates into higher interest rates or not being able to secure fixed rate terms for their mortgages. In many cases, this is not related to a consumer's desire to live in a luxury home, but rather to the simple happenstance of living in a geographic area where average homes carry relatively high price tags.

A number of private secondary market mortgage conduits have become interested in participating and focusing, almost exclusively, in the market above the FNMA/FHLMC mortgage purchase cutoff. MBA firmly believes that the amount of demand for housing during the 1980s will be enormous, and that, therefore, there is an ample market available to supply the needs of a variety of market competitors. The presence of more, rather than less, operating entities in that market will spur competition both as to price and product.

For this system of mortgage finance to operate efficiently, we must have a competitive secondary market. To impose mortgage purchase limits on FNMA and FHLMC at an arbitrarily low level disrupts the free secondary market, limits credit available to homebuyers in higher-cost areas, and tends to raise the overall level of mortgage interest rates.

Both FNMA and FHLMC have a Congressionally chartered public purpose to provide affordable mortgage credit to the full income range of creditworthy homebuyers. Both institutions have fulfilled this role consistently. Statistics prove that they have offered mortgage finance to varied strata of families, not just to families who could afford mortgages at the high end of the scale immediately below the mortgage purchase limit cutoff. Their average mortgage purchase price has always been well below the mandated limit, and roughly equivalent to the average purchase price of existing homes in the U.S. Indeed, there is no incentive whatsoever for either of these entities to remove themselves from these markets. The most common argument made for lenders to prefer high balance loans is that for the same processing and servicing costs they will originate a loan that will bring more profit. This incentive simply does not exist for FNMA and FHLMC. Secondary market securities are backed by mortgages of varying amounts that add up to the security face value. Depending upon the degree of underwriting review performed by the secondary market purchaser, there may be an added increment of work for lower balance loans than for higher balance loans, but this is insignificant. In fact, the preference is not to include too many high balance loans in a given pool of mortgages, because an early payoff of a large balance loan would accelerate the return of principal to the investor beyond what the investor may have originally planned.

Not only have FNMA and FHLMC adequately fulfilled their public purpose in the past, but they will continue to be subject to Federal legislative review and oversight, at least to some degree, so long as they retain their Federal charters. Their mortgage purchases will be subject to scrutiny to ensure that they will continue to provide a mortgage market for all types of purchasers.

MBA does not have the same faith that the private secondary market conduits will be willing or able to sustain their secondary mortgage market support during all phases of the economic cycle, particularly during periods of tight credit.

In 1978, a variety of large financial concerns were in the process of developing and marketing CMBS issues. As soon as interest rates skyrocketed and the availability of money tightened in 1979, the market activity dissipated. The few securities initiatives that took place over the next few years did not come to fruition for lack of available product and inability to market sufficiently large issues. Last year, the Senate Banking Committee version of the housing authorization bill, S 2607, provided for the total removal of the FNMA/FHLMC mortgage purchase limits. There was little, if any, opposition to to that provision. What, then, has made the difference this year? The answer is both simple and telling—lower interest rates have created the incentive to test the waters again. In light of this, MBA must question whether these private entities have the staying power that both FNMA and FHLMC have proven to have had throughout economic cycles. FNMA and FHLMC should be given the ability to purchase higher balance loans simply to ensure that high-cost areas of the country will have at least two alternative secondary markets during periods of rising interest rates.

Another benefit of allowing FNMA and FHLMC to provide a market for higher balance loans, on the same basis as they serve the rest of the market, is that their activity can serve to establish a benchmark for pricing private issuances and ensure that there is competitive pricing for loans in this price range. The presence of FNMA and FHLMC will simply keep other issuers 'honest' by providing another source of competition.

MBA firmly believes that the market is big enough to accommodate a variety of competitors, and, in fact, should be broadened as much as possible so as not to exclude the entities who have had a great deal of experience in marketing conventional loans — FNMA and FHLMC. A high-cost area increase in the mortgage purchase limits will allow FNMA and FHLMC to fulfill their mandate of expanding the affordability of mortgages to a greater number of consumers.

The failure to increase their mortgage purchase limits, on the other hand, effectively will begin to diminish the crucial role played by FNMA and FHLMC, thereby worsening the mortgage affordability problems already plaguing the majority of America's frustrated potential homebuyers.

MBA appreciates the opportunity to testify, and would be pleased to furnish additional information, if needed.

Senator TOWER. Thank you, Mr. Gourley.

Mr. Simpson.

STATEMENT OF WILLIAM A. SIMPSON, VICE PRESIDENT, MORTGAGE INSURANCE CO. OF AMERICA, PRESIDENT AND CEO, REPUBLIC MORTGAGE INSURANCE CO., WINSTON-SALEM, N.C.

Mr. SIMPSON. Thank you, Mr. Chairman. I am Bill Simpson, president and chief executive officer of Republic Mortgage Insurance Co., and my office is also in North Carolina. It's a privilege to be the third North Carolinian testifying this morning. I am vice president of the Mortgage Insurance Companies of America, a trade association of some 14 companies, and I would like to thank the subcommittee for the opportunity to present views on legislative proposals to improve the functioning of the secondary mortgage market and to describe the role of mortgage insurance in this aspect of the housing finance system.

I, too, will summarize our prepared statement and ask that the full statement be incorporated in the record.

MICA, the Mortgage Insurance Companies of America, supports very much S. 1821 and S. 1822. These bills have the potential for expanding mortgage loan investment beyond the traditional loans that now rely heavily on the support of Fannie Mae and Freddie Mac.

OPENING UP THE MARKET FOR INVESTMENT IN MORTGAGE SECURITIES

The legislation proposes to take the wraps off some of the SEC restraints and other controls and open up the market for investment in mortgage securities. Such action should be beneficial and streamline the process of placing mortgages into securities and attracting new investors into the marketplace.

However, as Government regulations are removed and tax incentives are introduced, all of us should be concerned about the quality of mortgages being included in mortgage-backed securities that will be created as a result of this legislation. Concern for quality of approved mortgages goes beyond the question of yield, uncertainties of principal retirement and the legality of the investment. Quality depends primarily upon the creditworthiness of the borrower, the current and future value of the mortgage collateral, the terms of the mortgage note, the degree of interest rate risk assumed by the borrower, and the performance of the company servicing that mortgage.

Whether the investor is to be a pension fund, another institution, or a private individual, this legislation should include adequate safeguards to insure an acceptable level of quality in the securities involved.

BASIC SAFEGUARDS FOR INCLUSION IN LEGISLATION

I will highlight some of the basic safeguards which have evolved in the private market and would suggest that these be considered for inclusion in the legislation.

No. 1, the loan amount should be restricted to no more than 95 percent of the value of the property. Section 860(b) of S. 1822 defines eligible mortgages for a TIM's to be up to 100 percent of value. Loans with no downpayment simply have too great a risk of default to be included in TIM's.

Second, the legislation should clearly prohibit the situation where the originator servicer of mortgages is also the mortgage insurer or an affiliate of the mortgage insurer. The insurer should operate at arm's length with the mortgage lender and retain the status of an independent third party who has proper capital reserves to back up the insurance to be issued.

Third, the impact of section 103 of S. 1821 may place a substantial burden on the organizations which rate investment securities. It also leaves unanswered a question of proper safeguards on mortgages placed in an unrated security or funded by the sale of unrated shares of beneficial interests issued by TIM's. Such unrated securities could be sold to individuals or institutions who do not have the capability of properly evaluating the quality of the underlying mortgages.

These two concerns could be addressed by a requirement for mortgage insurance on the individual mortgages involved in S. 1821 and S. 1822. A precedent for such a requirement would be the provisions of Freddie Mac and Fannie Mae's charters that require this insurance on all conventional loans with initial loan value in excess of 80 percent.

Additionally, in recent years, the rating organizations and investors have generally required additional coverage of the entire pool of mortgages by qualified mortgage insurers. Such coverage protects the investor from first dollar of loss up to a limit of normally 5 to 20 percent of initial amount of the pool. Requiring such individual and pool protection from independent insurers regulated by 50 State regulators and by Fannie Mae and Freddie Mac will dramatically protect the investment quality of securities involved in the proposed legislation.

As a final point, the Mortgage Insurance Companies of America applaud section 206 of S. 1821 which clearly prohibits the Federal Home Loan Mortgage Corporation from guaranteeing the mortgage-backed securities of others. In our testimony earlier this year we have oppposed the parallel amendment to Fannie Mae's charter. Congress should not permit these secondary agencies to be in the insurance business with the implied performance guarantee of the Federal Government and without the same regulatory requirements for capital and operations as private insurers.

Finally, we would caution in this period of deregulation of financial services and new loan instruments that changes which would create new conflicts of interest or encourage poorly conceived self-insurance by lenders or issuers of mortgage securities are not in the best long-term interest of the housing market. A lender, for example, who attempts to bear the risk of loss himself, as well as any entity, public or private, that attempts to perform the insurance function without established underwriting and reserve disciplines could result in excessive losses to mortgage investors.

In addition, lenders should be constrained from designing mortgages which are a good deal for the investor but are impossible financial obligations for most borrowers.

Again, we thank the subcommittee for allowing us to participate. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF WILLIAM A. SIMPSON, VICE PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA, BEFORE THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS ON S.1821, THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983 AND OTHER SECONDARY MARKET PROPOSALS.

September 21, 1983

Mr. Chairman and Members of the Subcommittee:

My name is William Simpson, President and Chief Executive Officer of Republic Mortgage Insurance Company located in Winston-Salem, North Carolina. I am the Vice President of the Mortgage Insurance Companies of America (MICA)* and on behalf of the Association, I would like to thank the Subcommittee for this opportunity to present views on legislative proposals to improve the functioning of the secondary mortgage market and to describe the role of mortgage insurance in this aspect of the housing finance system.

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* MICA consists of thirteen domestic private mortgage insurance companies and one Canadian company whose insurance-in-force on December 31, 1982 was $124.97 billion. The national officers are Leon T. Kendall (Chairman of the Board of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, President; William A. Simpson (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Vice President; Claude E. Pope (President of General Electric Mortgage Insurance Companies), Raleigh, North Carolina, Treasurer; Henry D. Felton (President of Commercial Credit Mortgage Insurance Company), Baltimore, Maryland, Secretary.

First, a brief statement about our industry:

Residential mortgage insurance has been an accepted and important part of the American housing scene for the past generation. During most of this period, the Federal Housing Administration (FHA) and the Veterans Administration (VA) have been the exclusive or dominant sources of mortgage insurance. In 1957, the creation of the first non-government mortgage insurance company signaled the end of the Federal Government's exclusive role in the insurance of residential mortgages.

There are presently fourteen mortgage insurers in business chartered by at least one state, and most of these are engaged in insuring residential mortgages on a national scale. All of these mortgage insurance companies (MICs) have been approved by the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) as qualified insurers of mortgages eligible for purchase in the secondary market for conventional loans operated by these two corporations.

Unlike the FHA, which insures 100% of the principal amount due on a mortgage, MICs insure only the top 20% or 25% of the mortgage, depending on the ratio of loan-to-value and the coverage desired by the lender who shares the risk with the MIC. In the event of default the MICs also have the option to pay the lender 100% of the amount due plus interest, taxes, etc. and take title to the property. Each MIC has several premium plans which vary according to the term of coverage, as well as the extent of coverage. All MICs are chartered under state laws and they are regulated by the various state insurance departments.

We strongly support the enactment of S.1821. The bill would amend the securities laws to reflect the increased marketing of a security which played a very minor role in the market when the Securities Acts of 1933 and 1934 were enacted. Two objectives have been announced for this legislation. The first is to remove any regulatory impediments which prevent mortgage securities from trading at least as well as other corporate securities. The second is to broaden investor interest in mortgage securities. These objectives are to be achieved within the context of fostering a responsive, strong, and in time, totally private secondary market.

MICA believes that enactment of S.1821 will bring investments in mortgages beyond the traditional limits established in today's secondary market. S.1821 would have the equally important result of enhancing the role of the private sector in the secondary market and thereby reduce reliance on the government-sponsored secondary market, specifically the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. We believe that both these agencies have made and continue to make a substantial contribution to residential mortgage financing. However, the ultimate objective of any government sponsored housing activity is to point the way toward greater assumption of such roles by the private sector. Private issues of mortgage backed securities have entered the market and this should be encouraged by removing statutory and regulatory impediments which inhibit greater penetration by the private sector.

In order to attract investors such as pension funds into the market for mortgages, meaningful protections must be available so that their investments have a verifiable quality. The best way to assure quality is to gain independence between certain aspects of the mortgage finance process. Mortgage insurers operate as independent third parties and the principles they have developed for the promotion of conventional mortgage backed securities should be preserved as enhancements are made in the secondary market.

One set of principles relate to loan underwriting and its value to investors in mortgage securities. FHA underwriting of loans has made a major contribution to the efficient operations of GNMA. The FHA developed a body of statistics covering every aspect of residential loans used in developing risk management procedures. In attempting to assure that a borrower's financial characteristics match the terms and conditions of a loan, underwriters can forecast a borrower's ability to avoid default with the mortgage under changing economic scenarios. The third party underwriting, whether done by the FHA or by a private insurer, protects the lender as well as the investor in the event the mortgage is subsequently sold in the secondary market. Thus, investors in mortgage securities such as GNMA's have a level of confidence in the soundness of the loans that make-up the underlying quality of the pools backing the securities.

We strongly urge that the legislation reflect the need for quality of the collateral as changes are proposed to remove legal and other impediments to the issuance of conventional mortgage securities. In 1970 when the major legislation affecting FHLMC and FNMA was enacted, Congress addressed this question of quality and the result was certain specific safeguards. In Section 103 of S.1821 there is a requirement that in order to be afforded the same treatment as securities described in Section 4(5) of the Securities Act of 1933, the mortgage security must be rated in "one of the four highest rating categories by at least one nationally recognized statistical rating organization." Rating agencies perform an important function and generally can set all the standards for investment quality. However, if the conventional securities are to have the full flexibility contemplated to result from enactment of S.1822 (relating to the TIMS program), then there may be an important need to permit securities that have not been rated to be issued free of such security law impediments.

There are many reasons for this to occur such as allowing smaller issuers to have complete access to the market. However, to balance new flexibility for issuers, the legislation should establish some safeguards and mortgage insurance can effectively perform this role. Non-rated securities could be required to utilize a number of mortgage insurance safeguards already adopted by the rating agencies and FNMA and FHLMC. We would recommend that an amendment be included in Section 103 of

S.1821 which would also include within the exemption conventional securities whose collateral meets the purchase requirements and the mortgage insurance requirements established in the Charter Acts of FHLMC and FNMA. This would permit such conventional securities to be free of the impediments along with underlying loans of 80 percent loan to value or less. Another layer of excess loss pool coverage of a specified amount also should be required to make nonrated mortgage securities eligible for the streamlined issuance procedures.

The effect of this amendment would be to permit the issuance of those securities for which private insurers have examined the collateral and insured the potential investor against financial loss. The underwriting and commitment by the private mortgage insurer to support the issuers commitment to make timely payments would obviate the need for a rating. The insurance coverage we propose substituting for the rating process would basically allow the investor to disregard the identity of the seller and the characteristics of the mortgages in the pool that bear on default and delinquency risks.

Also based upon this industry's underwriting experience, we recommend Section 860E(b) of S.1822 defining the type of mortgages eligible for a TIMS be amended. This section permits loans with no borrower equity to be pooled in TIMS. There is a need to recognize that conventional financing in excess of 95% of value involves excessive risks and amend the bill so that loans represent an equity interest by borrowers of not less than 5%. The statistical information from our industry and the FHA which is available summarizing loan risks on insured loans shows a geometric progression in the rate of default based upon loan to value. The chart below uses data from the FHA Section 203(b) program based upon loans insured during 1975 and 1977. These were 30 year fixed rate loans and were originated at the peak of the cycle when default losses were at their lowest. The risks illustrated below would be dramatically higher if the loans with adjustable rates, balloon features or negative amortization are compared.

[Loan to Value]	[Percent Going to Claim]
< 80	0.642
80-84.9	1.155
85-89.9	1.476
90-90.0	1.623
91-91.9	1.672
92-92.9	1.625
93-93.9	2.357
94-94.9	2.361
95-95.9	2.613
96-96.9	4.363
97-97.9	5.120
98-98.9	5.514

Source FHA 203(b) Book of Business 1975-77

The 98% loan is about two and one half times riskier than the 95% loan. Mortgages whose amounts equal the value of the residence and don't require some borrower downpayment as equity go beyond what has been a prudent limit in conventional residential financing. It is a practice that is inappropriate for TIMS or other conventional issues.

Mortgage insurers are appropriately positioned to play an important role in linking the homebuyers to the capital markets. Just as homebuilders who construct and sell homes, realtors who arrange the sales, and lenders who process and service loans recognize the importance of the secondary market in making financing available for homeowners, mortgage insurers have a special interest in seeing new developments in mortgage securities and the secondary market make financing not only available but workable for the homebuyer. Mortgage insurers' traditional role is to evaluate the financial risk that the homebuyer may default on his obligation. No other industry group has the same risk if a borrower finds a mortgage instrument or financing arrangement unmanageable. No other industry group has the same incentive to promote changes that will avoid the hardship upon consumers which occurs when there is a default.

The mortgage insurance industry has extensive experience in looking at risk variables resulting from mortgage instrument design and from the practices of appraisers, underwriters and security issuers. Default insurance has proven to be a dynamic concept. It has spawned the development of many additional services that facilitate the origination and sales of mortgages but its greatest potential lies in encouraging the private market to meet investor needs as they are perceived. If the principles adopted for this industry are adopted as the secondary market continues its evaluation toward total privatization it will make the transition smoother.

We strongly support Section 206 of S.1821 that makes it clear that FHLMC may not guarantee securities issued by another entity but may only guarantee its own securities. MICA testified against FNMA having this insurance function for reasons that it would be anticompetitive and could lead to less rather than greater reliance upon private enterprise. The FNMA or FHLMC role must not go beyond selling assets. The role of guaranteeing or insuring the quality of someone else's assets is a function requiring controls characteristic of the mortgage insurance industry.

MICA has strongly opposed a GNMA-type guarantor role for these agencies primarily because their expansion into the roles of insurer would be a major shift of housing policy. The preamble to the landmark 1949 Housing Act states that National housing objectives hereby established shall be (1) that private enterprise shall be encouraged to serve as large a part of the total need as it can, and (2), government assistance shall be utilized where feasible to enable private enterprise to serve more of the total need. To carry out this longstanding policy and if the government sponsored agencies are to become more private in performing various services, there is a need to reassess the level and type of reserves and other financial disciplines these agencies must maintain in order to offset the potential risks of such activities. Moreover, such new discipline must be equitable in regard to those existing for private entities with whom they would compete.

The GNMA-type guarantor role is one activity that illustrates our point about the anti-competitive effects of certain expanded agency functions. Private insurance firms cannot compete in the financial markets with the high ratings available to the securities of agencies backed by the Federal Government. The higher rating and lower required investment yield of agency securities is not competitive because in providing their agency guarantee Fannie Mae or Freddie Mac do not have to meet the same financial strength requirements that private insurers must meet. For example, in 1982 FNMA's annual report indicates it issued and guaranteed $14 billion of mortgage pass-through securities and the total reserves reported to be set aside for the foreclosure loss involved in those guarantees was $4.7 million. If the private insurance industry had guaranteed this $14 billion of securities we would have had to designate about $100 million of reserves and capital to back that insurance guarantee. This puts private insurers at a serious handicap. The government backing permits FNMA and FHLMC to sell their securities at 50 to 60 basis points below the yield that the same securities would require if privately insured.

In economic terms the role of an insurer or guarantor is to fulfill a risk transfer function. The insurer's solvency, (i.e. ability to satisfy obligations) and solidity (i.e. ability to provide continuity of the risk transfer service) are related to its reserves and it is generally accepted that the absence of reserve capital presents a level of peril to future operations.

In the case of an agency like FNMA, the marketing of its securities is dependent upon the government absorbing large unreserved liabilities. This is, of course, not available to private insurers that must meet levels of reserves specified by state rules and statutes. The privatization of the secondary market will not proceed unless the level of risk of the insurance function is accurately perceived.

In conclusion it is important to note that this legislation proposing to remove impediments to the private issuance of securities will come at a time when there will be constant change in the forms of mortgage instruments as well as structural market shifts resulting from financial deregulation. As deregulation continues, caution is needed to avoid conflicts of interest and other changes that could create serious risks in the marketplace. Modern mortgage insurers have weathered the tests of several business cycles and their contracts and practices are based upon a carefully studied structure particularly when it comes to the affiliations between mortgage insurance companies and mortgage originators. The problems of possible deception and self-dealing through subsidiaries has been eliminated under the modern statutory and regulatory treatment of mortgage insurance. We caution that new changes which would create new conflicts of interest or encourage potentially disasterous risks from self-insurance by lenders or issuers of mortgage securities are not in the best long-term interest of the housing market or the consumer. A lender who attempts to bear the risk of loss itself, as well as any entity public or private that attempts to perform the insurance function without the established discipline in the underwriting and reserve areas could create problems which would result in less rather than more investor interest in mortgage securities.

We thank the Subcommittee for requesting our participation in these hearings and the Association will provide any additional information that may be helpful.

Senator TOWER. Thank you, Mr. Simpson.
Mr. Lange.

STATEMENT OF GARY LANGE, CHAIRMAN, COMMITTEE ON MORTGAGE INVESTMENTS, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS/NATIONAL SAVINGS & LOAN LEAGUE, EXECUTIVE VICE PRESIDENT, THE SAVINGS BANK OF PUGET SOUND, SEATTLE, WASH.

Mr. LANGE. Mr. Chairman, my name is Gary Lange and I am executive vice president of the Savings Bank of Puget Sound in Seattle, Wash. I am appearing here today on behalf of the National Association of Mutual Savings Banks and the National Savings & Loan League. As you may have heard, our two associations are in the process of consolidating into one trade association which will represent both savings banks and savings and loans associations. The consolidation process began early in 1983 and will culminate in the launching of the National Council of Savings Institutions on November 1, 1983.

I am pleased to testify on the two bills, S. 1821 and S. 1822 introduced by you and the chairman of the full committee, Senator Garn. On the basis of our initial analysis, we have concluded that the sooner these bills, or similar measures, can be enacted, the sooner the thrift industry can continue an active mortgage lending presence in the deregulated banking environment in which we now find ourselves. We applaud your initiative and foresight in promoting these bills.

With the deregulation on the deposit side of our balance sheets, an asset-liability matchup program should preclude a thrift from making any 30-year fixed rate loans in their loan portfolio. However, the desire on the part of the consumer for a fixed rate, long-term mortgage is still out there. The problem is affordability.

The passage of these two bills or a combination of them into a single bill should help on both sides of these counts. Being able to still offer the 30-year loan and at the same time make it easier for the capital markets to access funds and hopefully bring down the cost of these funds can benefit the consumer, the homebuilder and the thrift institutions. There is still room for adjustable rate mortgages which are an excellent asset for a thrift and a good mortgage for many borrowers.

The ARM's make housing affordable for a larger percentage of the populace since the initial rate which is usually the qualifying rate will always be lower than a fixed rate.

I would additionally hope that the passage of these bills would help to open financing for multifamily housing which desperately needs long-term fixed rate financing.

One additional point I would like to make is found on page 8 of the written testimony. S. 1822 excludes Fannie Mae and Freddie Mac from TIM's, and we can certainly appreciate the sponsors' concerns about allowing the private marketplace to develop in as open an atmosphere as possible. However, we believe that the marketplace will benefit from the participation of these established secondary market entities since they will provide a degree of standardization that might not otherwise develop. We only have to look at the last few years with the hundreds of different ARM's to see how the market can be confused by a plethora of instruments. Furthermore, FNMA and FHLMC would speed up the time that the market needs to reach sufficient volume of these TIM's securities to assure full liquidity of these instruments.

You've heard in earlier testimony that it could take up to 5 years for a viable market to be obtained without Fannie Mae and Freddie Mac. I don't think the housing industry or the home buyer can wait 5 years. Additionally, these two organizations provide good competition and help to keep the private sector reasonable in their spreads and their fees. Further, both the National Savings & Loan League and NAMSB support higher loan limits for Fannie Mae and Freddie Mac in high cost areas.

Mr. Chairman, thank you again for the opportunity to testify and I stand ready to answer any questions that the subcommittee may have.

[The complete statement follows:]

Statement
of the
National Association of Mutual Savings Banks
and the
National Savings and Loan League
on
S. 1821 and S. 1822
before the
Subcommittee on Housing and Urban Affairs
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
September 21, 1983

Mr. Chairman, my name is Gary Lange and I am the Executive Vice President of The Savings Bank of Puget Sound in Seattle, Washington. I am appearing here today on behalf of the National Association of Mutual Savings Banks and the National Savings and Loan League. As you may have heard, our two associations are in the process of consolidating into one new trade association which will represent both savings banks and savings and loans associations. The consolidation process began early in 1983 and will culminate in the launching of the National Council of Savings Institutions on November 1, 1983.

I am pleased to testify on the two bills, S. 1821 and S. 1822, introduced by you and the Chairman of the full Committee, Senator Garn. On the basis of our initial analysis, we have concluded that the sooner these bills, or similar measures, can be enacted the sooner the thrift industry can continue an active mortgage lending presence in the deregulated banking environment in which we now find ourselves. We applaud your initiative and foresight in promoting these bills.

When the President's Commission on Housing published its report in the Spring of 1982, it listed several statutory and regulatory problems confronted by mortgage-backed securities (MBS). The report noted "mortgage-related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations." The report recommended several specific regulatory and legislative actions, and some of these regulatory changes have already been made:

- -- SEC has allowed "blind pools" which enable securities to be sold before the actual mortgages are made;
- — SEC has allowed "shelf registration" for multiple issuances of similar MBS;
- — Federal Reserve Board has amended Regulation "T" to allow MBS to be purchased on margin.

On the legislative front, however, the Administration has expressed general support for action but has yet to endorse any specific legislation. Your legislation, Mr. Chairman, follows through on the recommendations of the Commission's report, and I can say that both groups I am representing today, and our new group, the National Council, strongly support your efforts.

Why is it important for thrift institutions to be able to have a wider range of options with respect to mortgage-backed securities? The answer is that flexibility, manageability, and liquidity of assets are crucial to the successful functioning of depository institutions today. You no doubt recall the recent crisis faced by the thrift industry brought on in large part due to our principal reliance on long-term, fixed-rate mortgages. These assets continue to stay on our books as the cost of our funds has risen to historical highs, and these mortgages simply do not lend themselves to the complexities of today's financial marketplace. Adjustable rate mortgages are part of the answer but they are not the total solution, particularly in light of consumer preferences which may take years to become fully acclimated to alternative instruments.

The need for more manageable assets has been brought about by technological, market, and statutory changes that have made the flow of funds to thrifts a shorter-term, less predictable and more expensive phenomenon. According to figures of the Federal Home Loan Bank Board, the national average cost of funds to S&Ls insured by the Federal Savings and Loan Insurance Corporation (FSLIC) was 6.79% for the six-month period preceding January 1, 1979, 7.71% the next year, 9.11% the next year, and 11.53% the next. Now that the Depository Institutions Deregulation Committee has completed its work in scheduling the deregulation of interest rates on virtually all time accounts, the deregulation of interest on accounts, driven by consumer expectations and competition from new players in the financial services industry, is almost complete.

In spite of the existing limitations of mortgage-backed securities, thrifts have been moving to invest in them in increasing amounts. Last year, thrift institutions converted old mortgages into securities in such volume that over 90% of the business of the Federal Home Loan Mortgage Corporation (FHLMC) was devoted to these transactions know as SWAPs. In fact, the total volume of new securities formed from old mortgages last year was $32 billion. Why do institutions convert (or securitize) their mortgages, a transaction which does cost money? The answers are that securities can be sold more quickly and with less discounts than mortgages, that they can be used as collateral for certain loans, and that they offer asset managers other options. These reasons recently led Financial Corporation of America to enter in a $2.6 billion SWAP, the largest in the two-year history of these transactions.

When the question of new mortgages arises, the use of securities lends itself to risk management through hedging activities such as futures and options. In fact, the Government National Mortgage Association (GNMA) mortgage-backed securities have been traded in the futures markets for several years, and similar facilities are developing for conventional mortgage-backed securities. As thrifts attempt to match assets and liabilities in a world where the cost of liabilities can change on a daily basis, the increasing use of securities as assets will be a part of solving this complex problem.

Thus, between 1978 and 1982, the percentage of MBS as a part of mortgage-related assets (mortgages plus MBS) doubled for mutual savings banks (from 9% to 18%) and almost tripled for savings and loans (from 5% to 14%). The vast majority of these securities have been one way or another linked to the federal government. Of the outstanding volume of MBS at the end of 1982 ($183 billion, according to figures of the Federal Reserve), 61% are MBS guaranteed by GNMA, 18% were MBS issued by FHLMC, and not included in the Fed figures are the $14 billion outstanding in MBS issued by the Federal National Mortgage Association (FNMA).

The experience with the GNMA securities shows how effective securities can be, if they are structured to provide adequate soundness and yield to investors. Approximately 90% of all FHA and VA single-family mortgages originated last year were funded through the sale of GNMA MBS. While the comparable percentage for conventional mortgages funded with securities is relatively small (5% of conventional mortgages originated last year were funded through the sale of FNMA and FHLMC securities), it must be remembered that conventional mortgage-backed securities are in the early stages of growth.

S. 1821 and S. 1822 would establish the statutory foundation to assure the full development of mortgage-backed securities and assure America's homebuying public that there would be adequate supplies of mortgage credit in the years to come. Of equal importance, this legislation would enable the private marketplace to supply this capital, by enabling conventional mortgage-backed securities to compete in the capital markets.

S. 1821 has several important features that I would like to address. Section 105 would authorize national banks to underwrite and deal in mortgage-backed securities, and, since thrifts receive equal treatment pursuant to 12 U.S.C. 378, this section would also authorize other depositories to underwrite and deal in mortgage-backed securities.* While it is unclear how many individual institutions would avail themselves of this option, clearly some of them would and we strongly support this provision.

Section 107 instructs the Securities and Exchange Commission to allow shelf registration for similar offerings of mortgage-backed securities. We see no reason to expect that shelf registration for MBS would not reduce the costs associated with underwriting issues while maintaining the quality of the securities, as has been the case with use of this device for other types of corporate securities.

Title II of S. 1821 contains technical amendments to the charters of FHLMC and FNMA. The legislation does not include an increase in the mortgage purchase limits of these agencies. Both NAMSB and NSLL support an increase in these limits similar to the provisions that raise the limits for the FHA 203(b) mortgage insurance program, and we would suggest that this provision be included in this or other timely legislation.

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* Since the legislation only makes specific reference to national banks and because the Glass-Steagall Act has become the focus of so much litigation, we strongly recommend clearcut report language indicating that all depository institutions are covered by Section 105.

Mr. Chairman, I would now like to turn to S. 1822. While this legislation is in the jurisdiction of the Finance Committee, I think it is important that your Subcommittee is looking at it today. For the reasons I discussed earlier, the development of a wide range of mortgage-backed securities is important to the thrift industry. It is also extremely important to assuring an adequate supply of mortgage credit in the future.

S. 1822 is really at the heart of the Trusts for Investments in Mortgages (TIMs) concept. It attempts to change the structure through which MBS are issued to allow active management of the cash-flow generated by pools of mortgages. This is significant because the current treatment of these MBS under the grantor trust provision of the Code requires that pools be passively managed. Therefore, the issuer of the security must transmit all payments of interest and repayments of principal on a monthly, pro rata basis to all holders of securities. The grantor trust also requires that all securities tied to a specific pool of mortgages represent an equal and undivided share of the assets (the pool of mortgages). When these requirements are not followed, the flow of interest is taxed as it goes from the mortgagor to the securities issuer and then again when the issuer transmits that interest to the security holder. This double taxation makes the option of active management prohibitively expensive.

Passive management means that MBS are less desirable investment vehicles attractive primarily to certain institutional investors. All securities backed by the same pool of mortgages must have the same term (which means a fairly long term in the case of issues backed by new mortgages) and they can offer almost no call protection to securities holders.

S. 1822 creates a new section in the Internal Revenue Code that authorizes and sets guidelines for the establishment of trusts that can issue MBS. Securities backed by a pool of mortgages issued by a TIM may be issued in multiple classes, with varying payment streams, and offer call protection via reinvestment of principal payments from the pool of mortgages.

Basically, the legislation allows TIMs to:

- use interim assets as collateral to issue securities and then, within 18 months, replace these assets with mortgages;
- reinvest principal repayments from the pool that would provide call protection to investors when rates drop;
- establish multiple classes of securities with short-term securities' holders receiving principal repayments before holders of interim and long-term securities; and
- create bond-like investments with semi-annual payments of interest and payments of principal at maturity.

These steps can only make it feasible for new investors to purchase, either directly or indirectly, these housing-related securities, thereby expanding the investor pool from the traditional thrifts and pension funds, to include mutual funds and individual investors.

Under TIMs, as outlined in S. 1822, thrifts could establish their own TIMs and issue MBS secured either by mortgages purchased from other institutions, or originated by the issuer. Thrifts could garner new income from issuing the securities as well as the servicing of the mortgages in the pool. Since TIMs would attract new investors, opportunities for origination and servicing income for thrifts selling to TIMs would also be enhanced. These securities could be sold to institutional investors, such as pension funds, bank trust departments, insurance funds as well as to individual thrift customers.

On the other side of the transaction, thrifts could also invest in short-term mortgage-backed securities that would be allowed under TIMs. This would help match assets and liabilities, and, as the percentage of housing-related assets continued to shift from mortgages to securities, would lend itself to ever-increasingly sophisticated portfolio management. As thrifts have found in swapping old mortgages for securities, the securities are more liquid and manageable than the mortgages themselves.

S. 1822 excludes FNMA and FHLMC from TIMs, and we can certainly appreciate the sponsors' concerns about allowing the private marketplace to develop in as open an atmosphere as possible. However, we believe that the marketplace will benefit from the participation of these established secondary market entities since they will provide a degree of standardization that might not otherwise develop. We only have to look at the last few years with the hundreds of different ARMs to see how the market can be confused by a plethora of instruments. Furthermore, FNMA and FHLMC would speed up the time that the market needs to reach sufficient volume of these TIMs securities to assure full liquidity of these instruments.

Mr. Chairman, thank you once again for the opportunity to testify, and I stand ready to answer any questions the Subcommittee might have.

Senator TOWER. Thank you, Mr. Lange.

Mr. Green.

STATEMENT OF ROY GREEN, EXECUTIVE VICE PRESIDENT, U.S. LEAGUE OF SAVINGS INSTITUTIONS, WASHINGTON, D.C.

Mr. GREEN. Thank you very much, Mr. Chairman. I'm Roy Green, executive vice president of the U.S. League of Savings Institutions. Our organization appreciates this opportunity to testify on the Secondary Mortgage Market Enhancement Act. Virtually all savings institutions are anxious to continue their traditional role as the Nation's reliable source of mortgage credit year in and year out.

To fulfill that role, savings institutions have their own unique challenges, including those presented by what is now substantially a deregulated marketplace in the area of savings.

We also have a legacy of long-term portfolio loans entered into when fixed rates were in conformity with the then prevailing governmental policies. Those investments are earning well below the cost of attracting today's deregulated savings. We are making significant strides in modernizing the mortgage instrument itself. Together with the limited diversification made possible by the Garn-St Germain Act, this will help in restructuring our institutions so that they might better withstand hostile economic circumstances. But the single greatest hindrance to fulfillment of our mortgage credit purpose is our low-yielding loan legacy.

Today we are discussing legislation to enhance the secondary markets. The enhancements of greatest appeal to savings institutions would be, most assuredly, those which help us in the restructuring process and with low-yielding loan legacy.

The secondary market has performed a useful role in our mortgage credit delivery system and the subject matter of today's hearing, S. 1821, is designed to see that they function more efficiently, especially for securities backed by conventional mortgages.

We applaud several of these provisions, giving permanent status to the SEC's experimental shelf registration rule and extending exemption from registration to a broader range of mortgages. However, we have some reservations about the blanket registration exemption proposal for all HUD-approved mortgagees. It might be worthwhile to review the study of abusive practices in the Ginnie Mae marketplace a few years ago submitted to your Banking Committee by the Treasury, the SEC, and the Federal Reserve. Subsequent rules by the Federal Home Loan Bank Board and other banking agencies make a repetition of these problems unlikely for investors which are fully regulated depositories, but it would be tragic if other investors in the emerging mortgage-backed securities products were not fully protected.

Our statement also asks for parity treatment for federally chartered thrifts if national banks are authorized to underwrite and deal in mortgage-backed securities.

Our national vice chairman, Paul Prior, testified 4 months ago before this panel in support of several provisions of title II. At that time we opposed general authority for Fannie Mae to guarantee securities of third-party issuers. S. 1821 carries that guarantee prohibition one step further by clarifying that Freddie Mac would not have that authority.

In the intervening months several imaginative new instruments have been successful in attracting money market investors to mortgage finance, especially Freddie Mac's collateralized mortgage obligation or the CMO.

My written statement discusses a way in which a CMO might be utilized to help with our major restructuring challenge, the legacy of the below-market loans in our portfolios. Since the concept could be construed as a Freddie Mac guarantee of debt instruments issued by individual savings institutions, a limited purpose exception or clarification might be needed in the language of section 206.

In conclusion, Mr. Chairman, we commend you, Senator Garn, and this distinguished subcommittee, for exploring new ways to enhance the secondary markets. We applaud the objective of broadening the availability and lowering the cost of mortgage credit for the American people. We hope that savings institutions can assist as a primary participant in that delivery process.

We thank you very much and look forward to answering your questions.

[The complete statement follows:]

STATEMENT OF ROY G. GREEN

ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

BEFORE THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

September 21, 1983

Mr. Chairman:

My name is Roy G. Green of Washington, D.C. I am Executive Vice President of the U.S. League of Savings Institutions*.

The U.S. League is pleased to present this testimony on S. 1821, the "Secondary Mortgage Market Enhancement Act of 1983."

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*The U.S. League of Savings Institutions, formerly the U.S. League of Savings Associations, has a membership of 3,500 companies representing over 99% of the assets of the $730 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. Recently, many prominent savings banks have joined the League as members. The principal officers are: Leonard Shane, Chairman, Huntington Beach, California; Paul Prior, Vice Chairman, New Castle, Indiana; William O'Connell, President, Chicago, Illinois; Stuart Davis, Legislative Chairman, Beverly Hills, California; and Roy Green, Executive Vice President, Phil Gasteyer, Legislative Counsel, Jim Freeman, Senior Legislative Representative, Washington, D.C. League headquarters are at 111 East Wacker Dr., Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N. W., Washington, D.C. 20006. Telephone: (202) 637-8900.

As you may know, Mr. Chairman, I only recently assumed my current post as Executive Vice President of the U.S. League with overall responsibility for the direction of Washington operations. Prior to that I served for more than twenty-five years as managing officer of three separate savings and loan associations in different parts of the nation -- most recently, First Federal Savings of Jacksonville, Florida. Of some relevance to today's hearing, that institution was an active participant in the secondary market. Furthermore, for the past dozen years I have served on the League's committee which monitors the programmatic and policy directions of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, as well as private secondary market developments.

HOMEOWNERSHIP AND THE AFFORDABILITY GAP

For the past several months, a blue-ribbon panel in our organization has been involved in an exhaustive review of the housing and mortgage credit markets: our Home Ownership Task Force. They are mid-stream in the process of issuing a series of Discussion Papers. The first such paper, distributed in July (and shared with the members of this distinguished Subcommittee) examined the challenges facing homeownership in the 1980s: increased demand for loans (as the Korean War baby-boom reaches family formation age) while the ratio of "prime savers" to "prime borrowers" suggests a shortage of private savings, the capital shortage aggravated by the demands of a Federal Government funding $200 billion deficits, the volatility of deposits in a deregulated savings environment, and the cyclicality of homebuilding and real estate sales. The second installment of the Task Force's work focuses specifically on the growing "affordability gap". It is to be released tomorrow and we will be happy to make it available to the Subcommittee and participants in this hearing.

Both discussion papers document some sobering trends. After four decades of upward movement, the national rate of homeownership is now in decline. Arthur Young, the U.S. Census Bureau's chief of housing, estimates that as many as 10 million families -- who could have achieved homeownership in earlier decades -- could be denied that opportunity in the 1980s. New ways must be found to address this "affordability gap". The gap, of course, is the result of a combination of factors, including the cost and availability of mortgage credit, housing prices (reflecting productivity and efficiency in the housing industry, land prices, and the hidden costs of government regulation), and the disposable income available to families for home purchases. As of July 1983, the median-income household still faced a $16,250 deficit between the cost of the house it could afford and the median cost of new houses offered in the marketplace. If the backup in mortgage rates of the past few months (from 12.5% to near 14%) and current housing prices persist, that gap could widen further.

The immediate concern to the savings institution business and to the authors of S. 1821 is the task of reducing the cost and increasing the availability of the mortgage credit component in the affordability equation. The savings and loan and savings bank industries proudly served as the nation's primary delivery system for mortgage credit throughout the decades of the '50s, '60s, and '70s. Our member institutions are anxious to continue to perform this role, and are doing so, as demonstrated by recent figures from the Federal Home Loan Bank Board. Associations closed $12.0 billion in mortgage loans in July, a record for that month (on a seasonally-adjusted basis). The July statistics follow an all-time record of $13.8 billion in loans closed in June. New mortgage commitments, at $14.7 billion for July (with $31.8 billion in outstanding commitments, also a record), are further evidence of our desire to finance home ownership for Americans. Admittedly, these figures reflect markedly improved market conditions in the early months of 1983, with inflation subsiding and lower interest rates generally.

In no small measure, this performance is also a tribute to the work of your parent Banking Committee in the last Congress and its development of the Garn-St Germain Depository Institutions act of 1982. The preamble to that landmark achievement stated as its purpose:

> "To revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans."

Our institutions are trying to fulfill that purpose -- not just in the near-term, but over the long haul. We believe that thrift institutions can remain the most dependable source in our nation's delivery system for mortgages. One of the tables in our soon-to-be-released Discussion Paper #2 documents the reliability of various sources of mortgage credit since 1970. The steadiest participant in mortgage finance, year-in and year-out, has been savings institutions. Certainly our record demonstrates that we are not "fair weather" friends of home ownership.

However, with our deposit base now substantially deregulated, we must still overcome some remaining legacies of the past. We are making significant strides in modernizing the mortgage instrument itself through the marketing of a variety of adjustable rate mortgages. And, with the enactment of Garn-St Germain, there are new opportunities for some limited portfolio diversification into higher-yielding investments such as commercial real estate loans, consumer loans, and lending for general commercial purposes. This diversification can help our institutions withstand hostile economic environments.

THE LEGACY OF LOW-YIELDING LOAN PORTFOLIOS

Yet, the single greatest handicap with which we must deal is our legacy of low-yielding, long-term, fixed-rate mortgages -- entered into at 7%, 8%, 9% rates for fixed, 25- and 30-year terms in conformity with then-prevailing Government regulations. These investments return far less than the cost of attracting fresh, market-rate funds to our institutions. It was this asset-liability mismatch which led to our severe earnings crisis in 1980, 1981, and 1982 and the accompanying disappearance of hundreds of home-town thrift institutions across the country. We must continue to cope with some very sobering statistics: 55 percent of the mortgages on our books are earning less than 10%, and 30 percent are under 9%. Many of these loans have 20 or 25 years left until maturity. Despite the record volumes of new lending in recent months, no more than 20 percent of our portfolios earn above 12.5%.

Overall, our portfolio yield today is 10.6%. Our cost of money, reflecting the upswing this summer in short-term money rates, is near 10%, giving us an operating spread of less than 1%. While this is a vast improvement over a year ago, when the spread was a negative 1%, it is not enough to compete very effectively and rebuild net worth. And, it is far below the historical 1.75% spread between yield on investments and cost of funds under which our instisutions operated successfully for decades.

One important approach to coping with the low-yielding loan legacy is to explore new ways in which these portfolio loans can be"monetized", or put to work. Mortgages, even those with yields significantly below-market, can be superb investments. Homeowners are extraordinarily diligent in meeting their monthly payment obligations and, particularly in periods of rising home prices, the value of the underlying security property is likely to remain intact. When "securitized" they can be packaged in a form relatively worry-free for investors, with geographical dispersion in the underlying pool further reducing investment risk. However, they do have drawbacks for money market investors: home loans may be paid off well before maturity (a "call protection" problem), their long maturities may not appeal to many potential investors, and cash flow may be interrupted -- though recent secondary market innovations are addressing these shortcomings in imaginative ways.

Furthermore, from the perspective of thrift institutions, monetizing the low-yielding portfolio is financially difficult. If the loans going into the pool backing the security are sold outright and they are below-market, the institution must recognize as a loss (under Generally-Accepted Accounting Principles) the difference between face value and the market yield. If the selling institution has low net worth, as so many do following the 1980-82 crunch, recognition of this loss aggravates its financial condition.

The "enhancements" of the secondary market of greatest appeal to savings institutions would be, most assuredly, those which can help with this low-yielding loan legacy.

TITLE I OF S. 1821

As stated in the Section-by-Section analysis of S. 1821:

> "the amendments of Title I will allow flexibility in mortgage security transactions and expand the potential base of investors and thus substantially enhance the ability of private issuers of mortgage securities to provide liquidity to mortgage lenders and reduce the costs of mortgage credit for homebuyers."

The U.S. League and its members share the sponsors' interest in achieving these worthy objectives. We would like to address some of the specifics of the legislative proposal.

Section 101 makes a number of changes in the exemptions from registration requriements found in the Securities Act of 1933. These broadened exemptions should improve the ability of conventional mortgage-backed securities issuers to package efficiently and market their products. The League welcomes the broadening of the exemption to include mortgages backed by pools of second liens, cooperative housing shares, and loans on manufactured housing. The clarification that a minimum issue amount of $250,000 means an initial issue size, irrespective of prepayments occurring between time of pool formation and securities issuance, is potentially beneficial to smaller depositories utilizing conventional mortgage-backed securities. Permanent status for the SEC's experimental shelf registration rule is also beneficial.

We have some reservations, however, about the language broadening the current registration exemption of Section 4(5) to include any HUD-approved mortgagee and the provision lengthening the period between commitment to purchase and cash payment for the MBS from 60 to 120 days. We also understand that the SEC has some concern about the change which allows mortgage-backed securities purchasers to buy for another person's account.

The SEC, the Federal Reserve and the Treasury submitted to your full Banking Committee on December 5, 1980 a detailed 237-page study on abusive practices in the marketplace for Government National Mortgage Association pass-through securities. The study documented various problems including overcommitments in connection with forward transactions, misuse of customer funds and securities, churning, and questionable sales practices by issuers and dealers. Several unregistered dealer firms collapsed, with adverse impact on yields in the marketplace. The victims included a major university and several depository institutions which had been induced to speculate on interest-rate movements through sizable Ginnie Mae forward contracts.

Subsequently, the Federal Home Loan Bank Board and other financial regulatory agencies placed strict controls on all forward commitments by the depositories under their jurisdictions. (See, for example, 12 CFR 563.17-3, which limits such exposure to 5%-of-assets for FSLIC-insured institutions with less than 3% net worth, 10%-of-assets if net worth is less than 5%, and 15%-of assets if net worth is above that point, along with requirements for oversight by boards of directors and careful documentation to assure funding when forward commitments are due.)

While we would certainly hope that the problems detailed in the study for Ginnie Mae mortgage-backed securities would not be repeated as the market develops for new types of securities backed by conventional home loans, we would recommend a careful reexamination of the Treasury-SEC-Federal Reserve study by your Subcommittee with that possibility in mind. In particular, it is important to recognize that the qualification standards of mortgagee approval by HUD and regulatory oversight thereafter fall far short of those which apply to supervised depository institutions, with their periodic examinations and substantial capital requirements. When non-depository firms are encouraged to participate as conventional mortgage-backed securities issuers as well as originators -- through a blanket '33 Act exemption -- it is essential that investors are fully assured of the quality of their operations.

If investor confidence is to be achieved in the broadened marketplace for conventional mortgage-backed securities, it is vital that adequate securities registration standards be upheld. Otherwise, these promising developments could hinder, rather than enhance, the quest to attract new sources of credit for housing.

Savings institutions, of course, will sometimes be investors as well as originators/issuers of conventional mortgage-backed securities. (As such, improved MBS products help perform the traditional secondary market function of moving capital from areas of shortage to those of surplus.) In this regard, the Home Owners' Loan Act change in Section 104 of S. 1821 -- which adds mortgage-backed securities to the list of permissible liquidity investments for federally-chartered thrifts -- is welcome.

As introduced, Section 105 broadens the ability of national banks to underwrite and deal in housing revenue and GNMA-guaranteed MBS by including private-issuer mortgage-backed securities, as well. The U.S. League asks that this authority be extended to federally-chartered savings institutions by appropriate change in the Home Owners' Loan Act. It is particularly important that these new products be made available to smaller, hometown thrift institutions -- which may, in turn, be able to design over-the-counter mortgage-backed products for local investors.

TITLE II OF S. 1821

Our national Vice Chairman, Mr. Paul Prior, testified on May 5 before your distinguished Subcommittee on several of the items appearing in Title II of S. 1821. He announced at that time the support of our organization for:

#- Statutory flexibility for FNMA and FHLMC to issue preferred stock in compliance with New York Stock Exchange rules;

#- Authority for FNMA and the FHLMC to purchase subordinate (second) mortgages in general -- not just those where the proceeds are dedicated to "home improvement" and "energy improvement" purposes; he suggested further that mortgagees be permitted to establish a reserve for coverage of the excess of such loans above 80%-of-value as well as purchase private mortgage insurance for the overage;

#- Statutory change to clarify that the FHLMC may purchase manufactured home loans where the security property is considered a mix of personalty and realty;

#- And, language to enable the FHLMC to open its conventional purchase programs to State-agency-insured loans.

At the time of Mr. Prior's statement, the League also testified in opposition to a Fannie Mae request for authority, as a matter of parity, to guarantee mortgage-backed securities "issued" by FNMA-approved lenders (rather than just those backed by mortgages purchased by FNMA). We expressed a concern that generalized authority to guarantee third-party MBS issues might undermine Fannie Mae's existing program for regular seller-servicers.

The authors of S. 1821 have omitted the Fannie Mae request. In addition, they have sought to clarify the ability of Freddie Mac to sell its guarantee generally by proposing in Section 206 that FHLMC may not guarantee securities issued by another entity.

In the intervening months since our testimony on the "guarantee" subject, some important new structures have emerged in the mortgage-backed securities markets -- most notably, the development of a highly successful Collateralized Mortgage Obligation (CMO) by Freddie Mac. The CMO is a corporate debt obligation of the FHLMC, but it achieves some important objectives for broadening the market for mortgages: it was ingeniously designed to appeal to three distinct classes of investors (those interested in short, 5-year, intermediate, 12-year, and long, 30-year, maturities); and it largely overcame the "call protection" fears by applying early prepayments first to the shorter debt. However, one disadvantage was that savings institutions providing loans to form the pool backing the CMO had to sell those loans. That would make it impractical for some institutions if, in the future, a CMO was designed in this way to monetize below-market loans -- since a sale triggers an accounting loss.

The FHLMC's CMO mechanism might, however, be helpful for dealing with the foremost problem of thrift institutions today: the legacy of the low-yielding loans gathering dust in our investment portfolios. Using the FHLMC as a "conduit", a marketable security might be developed which could monetize some of those low-yielding loans. However, to work, the Mortgage Corporation (and Fannie Mae) would need to have some, perhaps special-purpose, guarantee authority. Section 206 of S. 1821 would have to be amended.

The design of such a product could be as follows:

1. A thrift institution would issue its own debt instrument secured by some of the conventional below-market loans in its portfolio; since these loans are not sold -- but merely borrowed against -- there would be no accounting loss realized.

2. Freddie Mac would purchase the institution's debt instrument and put it into a pool of similar debt instruments issued by other FSLIC- or FDIC-insured thrifts.

3. Freddie Mac would then issue a Collateralized Mortgage Obligation (secured by the mortgage-backed debt purchase from the thrifts), with perhaps a series of maturity ranges to appeal to various segments of the capital markets.

In effect, Freddie Mac (or potentially, Fannie Mae) would be guaranteeing the debt of the originating debt issuers, the participating thrift institutions, and then using their debt as collateral to support the sale of its own FHLMC security in the marketplace. The arrangement is a way of putting the dormant, below-market portfolio loans to work. The fresh capital attracted would be channeled back so that new loans can be made in local communities.

This financing mechanism is similar to the pay-though or cash-flow bonds issued by some of the largest depository institutions in the past year. However, to succeed, those issues often depend on name recognition and bond ratings which are generally not available to smaller, local thrift institutions. But with the FHLMC as conduit -- and its excellent reputation and experience in the marketplace -- the CMO might attract funds for a smaller thrift particiant, and at a cost savings of 250 to 300 basis points.

The mechanism could have these additional advantages:

#- It would accelerate the restructuring process for participating thrift institutions (and relieve the lingering risks of institutional failure and liability for the FSLIC fund);

#- It does not require a loan sale, an inhibiting factor in restructuring at institutions with depleted net worth;

#- It fulfills one of the original purposes in establishing Freddie Mac in 1970 -- that is, to provide an additional source of liquidity for the thrift industry;

#- And, by contrast with the "warehousing" plan which I advocated before your Committee during testimony in March, 1982, it involves no costs to the Federal Government or any budgetary impact.

Of course, I cannot predict with any certainty the capital market acceptance for such a guaranteed debt instrument. Nor, given the capital resources of the FHLMC, can I forecast the volume of such issues or the "dent" they could make in the low-yielding portfolio problem. The plan could, however, make some contribution to the pace of restructuring and the willingness of thrift institutions to resume their mortgage credit role.

Again, to work, this mechanism would require some exception to the blanket prohibition on guaranteeing of securities issued by other entities found in Section 206 of S. 1821.

TRUSTS FOR INVESTMENT IN MORTGAGES (TIMs)

While we appreciate that S. 1822, Trusts for Investments in Mortgages (TIMs), is not part of the official subject-matter for today's hearing (since, as a tax law change, it falls within the jurisdiction of other Committees), we wish to compliment Chairmen Garn and Tower for prying loose a draft from the Treasury of legislative language. TIMs has been a hot discussion topic in mortgage finance circles since the concept was first explored two years ago by the President's Commission on Housing. However, the lack of any specific proposal has delayed meaningful and critical examination. The introduction of S. 1822 at least gives the financial community something to work with, though -- I am recently informed -- it appears that an updated version will be forthcoming from the Treasury.

Thus, I will limit my remarks today to a few general observations and reserve judgment until a firm legislative proposal is the subject of hearings in the appropriate Congressional Committees.

As the preceding discussion has suggested, even without the trust device of TIMs, imaginative new ways of packaging conventional mortgages are proceeding every day. If, as the sponsors of S. 1822 state, TIMs can "broaden investor interest" in mortgage-backed products still further, the U.S. League and its member institutions will be most interested in its development.

Advocates of TIMs point out that the structure does address several of the inhibiting factors in attracting investors to mortgage products: irregular cash flow, indefinite maturities in the underlying mortgage pool, and lack of "call" protection. The use of a non-taxable trustee, as with a Real Estate Investment Trust (REIT), potentially can lower ultimate costs because there is taxation only at the shareholder level. And the ability of the TIMs trustee to manage actively the corpus of the trust overcomes the tax code impediments to the traditional "grantor trust" mechanism which is applied only awkwardly to mortgage-backed securities. The mechanism would also sidestep a troublesome problem with collateralized debt alternatives which arises from the FSLIC's prior claim on mortgage assets of insured institutions in the unlikely event of a liquidation of the issuer. It is important, too, that

TIMs be available to neighborhood and rural depositories -- not just the biggest financial institutions.

The savings institution business would find TIMs especially helpful if it could be put to use as part of a restructuring strategy and assist with the low-yielding portfolio loan program described above. To accomplish this, it will be important that any statutory changes make clear that the original issue discount provisions of the Internal Revenue Code are not triggered when below-market loans are contributed to the TIM.

In addition, some thrift institutons may be interested in TIMs products as investors; where that is the case, it would be most helpful if the legislation provided that TIMs met the requisite tax code definition for "qualifying real property loans".

I would also observe that if TIMs are as successful as their advocates hope, the private conventional loan market might well be able to replace at least some of the role played by FHA/VA loans and the Government National Mortgage Association's pass-through securities program. The administered interest rates on FHAs, as we have testified so often before, distorts the entire mortgage market. The explosive growth of Ginnie Mae's is, in our view, a negative development for the overall delivery of mortgage credit by private sector financial institutions -- since the dominance of that program sets the benchmarks for the entire secondary market.

Finally, I would sound a somewhat precautionary note about TIMs. The REIT experience of the early 1970s is still fresh in our memories. The collapse of that specializd mortgage industry created lingering problems of investor confidence which drove up costs for all types of mortgage finance. As a matter of public policy, we must take care to avoid the re-creation of those problems through undue encouragement of non-traditional, unsupervised sources for mortgage credit.

PRIVATIZATION PROPOSALS

Your Subcommittee was wise, in our view, to defer legislation at this time on various approaches to "privatizing" the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

We are sympathetic with the enormous financial problems faced currently by Fannie Mae. Without continuation, at least in the near-term, of the several Government supports provided FNMA, these problems could be irreconcilable. I hasten to add that these problems are in no way the fault of the present and talented management of the Association. They have inherited, like thrift institutions, an enormous protfolio of below-market assets acquiried under then-prevailing Government policies. The Fannie Mae portfolio legacy is especially burdensome since $45 billion of the loans involved are FHA/VAs, where assumptions are specifically permitted; thus, many of these loans will stay on Fannie's books for many years to come.

Since it has not operated as a portfolio lender, Freddie Mac does not share these problems. Indeed, the Corporation has achieved an enviable level of financial strength -- a situation which makes it well-suited to perform the conduit role for its depository institution users and help them, in turn, cope with their own portfolio legacy problem.

As the Subcommittee knows, the FHLMC was initially capitalized by the 12 Banks of the Federal Home Loan Bank System. The U.S. League is intrigued by the suggestion that the Corporation be converted to totally private status by distribution of its stock to the Banks, and through them, to the member institutions of the Bank System. Our organization is actively studying that proposal and we will keep the Subcommittee informed as detailed recommendations are worked out.

CONCLUSION

In conclusion, Mr. Chairman, we again commend you and Chairman Garn for exploring new ways to enhance the secondary markets -- potentially broadening the availability, and lowering the costs, of mortgage credit for American homebuyers. We are hopeful that, in the process, portfolio lenders victimized by high interest rates and outmoded Government restrictions can speed their restructuring so that they can continue in the the future to perform as the reliable, and primary, delivery system for home finance. That is the role we have played traditionally -- an assignment repeated in the preamble to last year's Garn-St Germain Act. The end result, we hope, will be a reversal of the recent and disturbing decline in the percentage of home ownership for the American people.

I have appreciated this opportunity to present the views of the U.S. League and look forward to your questions.

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Senator TOWER. Thank you, gentlemen, for some excellent testimony. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Gourley, you call for high cost area increases in the $108,000 mortgage limit that we've been referring to this morning. I'm just wondering what problems have mortgage bankers across the country found with the current ceiling?

PROBLEMS WITH CURRENT CEILING

Mr. GOURLEY. In numerous areas, $108,300 is limiting. In my area of the country it's not except in a couple areas. In North Carolina and South Carolina it doesn't really bother us. Charleston, S.C. is one that's a high-cost area of FHA—that they do need that sort of relief. It's not a problem everywhere by any stretch of the imagination, but there are in a number of places—you mentioned in D.C. and California—there are lots of places where this has been a limiting factor and because we have been dependent as mortgage bankers have been dependent on the secondary market for so long. That's what we deal in, we do not own any loans for investment—we have grown to depend on Fannie Mae and Freddie Mac. There's other competition that's developing and this is great because I'm a member of the private sector and I'm a total believer in being competitive in all aspects. But for affordable housing and affordable mortgages in all of our areas, we are not ready with the conduits yet to substitute for them. As we said in the testimony, it's timing more than anything else. Over a period of time—they are already proving it and thank goodness—RFC and others have come in and helped supplement the market. They've taken a share of the market, and helped us considerably in our areas because even though we don't need regular limits over $108,300, we still produce a $200,000 or $300,000 home once in a while and it's great to have another source and we encourage the development of all of them. But we do know we still need FNMA and FHLMC and will need it for a period of time.

I mentioned and we talked about the development of the market. Ginnie Mae was started in 1970. In 1983, 13 years later, it is a very, very outstanding operation, but it took at least 8 years to get it rolling and it has really grown over the past few years. So the development of the market we would expect to take 5 to 10 years.

Senator RIEGLE. Why couldn't we just assume that the private companies would adequately serve the market for mortgages above $108,000?

Mr. GOURLEY. Primarily right now it's the delivery system—two things—one is they're not ready with the overall product. They've gained and we would help do that. The delivery system which is improving but does not exist today. RFC does have 1,600 correspondents. As I say, we are one of those. We have latched into all sorts of conduits. We've worked all around the various companies in conventional mortgage backed securities. But at this particular moment there's not the delivery system that works. We have Fannie Mae and Freddie Mac that are there and ready to go on all fronts.

Senator RIEGLE. What if the ceilings are raised maybe on the basis that sort of dealt with the high cost areas? Do you think if that were done that that would really hinder the development of the private market?

Mr. GOURLEY. Well, it clearly would slow down some of the opportunity, yes.

Senator RIEGLE. Seriously hinder it?

Mr. GOURLEY. I cannot see how it would seriously hinder it because we're still going to use them and certainly the yields that they are demanding or requiring as we deal with them have narrowed substantially as they have come in and we have always been dependent on the standardization. The things that Freddie Mac and Fannie Mae have done that helped make this market for all of us and at this particular moment the standardization is still developing and we still need very much that discipline of the marketplace.

Senator RIEGLE. Mr. Green, let me ask you, you changed positions—or the organization has on the question of raising the ceiling and I'm just wondering, is the League as one on this issue or is there really strongly divided opinion within the League as I gather there may be?

Mr. GREEN. Senator, there are people who take a different view. In fact that's unquestionably it. But I think the great majority of our people feel, especially right now, there's lots of liquidity in the system and the private secondary marketplace does have the money to take these loans. When we're talking about a $108,300 loan, we're talking about a family income of almost $60,000 to justify that. I really question the need in this particular area for Government to be in essence creating a conduit for this price-range house and family income. The private market is out there. It has the money to take these loans and I think they're anxious to do it.

Senator RIEGLE. Wouldn't those tend to be dress loans in the sense that they tend to be on more valuable property probably and in a more valuable real estate area and well supported by owners to have a stronger income stream?

Mr. GREEN. I think that's right.

Senator RIEGLE. Aren't they sort of the cream of the mortgage market in a sense?

Mr. GREEN. Well, we take the position that for people who own homes and live in them, all home mortgages are super quality investments. But you are exactly right. The higher income category does an excellent job in fulfilling their mortgage payment obligations.

Senator RIEGLE. Now in your written testimony you raise a question flag over some provisions in S. 1821 that would exempt any privately issued mortgage-backed securities and Federal and State securities laws and that's a matter of concern to me too. I want to encourage the growth of the market in privately issued securities, but I want to do it in a way that's going to make sure that investors are not exposed to unreasonable risks. Some complain that that really is an exaggerated concern because the purchasers of these kind of securities are generally sophisticated and look at them carefully and, therefore, you would not need to have as much in the way of protection on it that would be reported by SEC registration or the State securities laws.

But I'm wondering if it would be your view that we would still run into a problem where if there were fraud practiced by a few individuals, which is really the risk that we have to think about here, might not that have an effect that could end up in a sense jeopardizing the growth of the whole industry which I think all of us want to try to see take place?

Mr. **Green**. Absolutely, Senator Riegle. In addition to that investor risk concern that we have, we're really attracting new people into the marketplace to provide needed funds for the housing marketplace, and if we take people into this particular arena and use some practices that would not be time honored and completely safe, it might raise the costs by driving these people out of the marketplace once again because the people would just be very concerned if they had gotten stung one time.

Senator **Riegle**. Let me pose this question, again to you, but I'd like others to respond if they have a feeling about it.

You clearly stated why S&L's can't continue what is thought of as sort of a risky practice, as recent experience has shown, of financing long-term home mortgages with short-term finance deposits with interest rates fluctuating as they have, and you have outlined the problems that many S&L's still have because they're loaded with lower interest, fixed-term assets and are in financial difficulty and stress because of that. This is a problem that concerns this subcommittee and the committee very much.

S&L'S MAY NEED HELP FROM FHLMC

You indicate that many S&L's may need help from Freddie Mac's authority to provide guarantees on mortgage-backed securities issued by other corporations.

Now S. 1821 in its current form would remove that authority which is an authority that, of course, has never been used. Some believe that Freddie Mac would unduly dominate the mortgage-backed securities market and would use that authority extensively and I'm wondering, first, if there's agreement with that; and why couldn't the S&L's not use the authority provided under this bill to secure ties with low-yield mortgages without the use of Freddie Mac guarantees?

Mr. **Green**. Well, Senator Riegle, they could do that to a degree. However, there are many institutions out there that really just don't have the long-term earnings record, especially in view of what's happened the last couple of years, to be able to be a significant and quality issuer of debt securities. The use of the Freddie Mac conduit with the credit standing that they have and because of their unique relationship with the savings and loan industry over the years—we feel that Freddie Mac would be a perfect vehicle to be the intermediary between the savings and loan industry and those capital markets.

Senator **Riegle**. Did anybody else want to comment on that?

Mr. **Simpson**. Well, we addressed it in our testimony. We'd just like to emphasize that with Freddie Mac in the role of guaranteeing the performance of securities of others, it places them in the role of an insurance company. Obviously, with the backing of the Federal Government, it brings unfair competition in. We have as a private industry enough competition from the Government in the form of FHA and GNMA and in some degree Freddie Mac and Fannie Mae's own guarantees that are in securities, without the introduction of that problem.

I would be sympathetic to Mr. Green's problem of the S&L's of using specifically the CMO vehicle, which is a different animal than what Freddie Mac and Fannie Mae have been doing. A limited form of guarantee for that kind of paper might make sense. We would just be concerned that once you break that precedent, where do you stop?

Mr. **Green**. I'd just like to add that there possibly should be some strict limitations on which institutions could use these, which mortgages constitute the underlying security. We would envision these being such old mortgages that there would be no question of risk here. We're not talking about, Mr. Simpson—something that we would need insurance—because these loans would be so old that they would have no element of risk attached to them in our estimation.

Senator **Riegle**. Well, I want to agree with the chairman that I think the testimony of all of you on the panel has been very valuable and important to us and I thank you for it.

Senator **Tower**. Gentlemen, thank you very much. This has been enormously useful. I think we are building a very good record in response to this legislation. We thank you for your contribution. Thank you very much.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

THURSDAY, SEPTEMBER 22, 1983

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Housing and Urban Affairs
Washington, D.C.

The subcommittee met at 10 a.m., in room SD-538, of the Dirksen Senate Office Building, Senator John Tower (chairman of the subcommittee) presiding.

Present: Senators Tower, Gorton, Riegle, and Proxmire.

OPENING STATEMENT OF SENATOR TOWER

Senator Tower. The committee will come to order.

Yesterday, as in the past, we have heard many state that the mortgage purchase ceiling of $108,300 absolutely must be lifted for Fannie Mae and Freddie Mac. The argument goes on to point out that these high cost, or jumbo mortgages, must be available to Fannie and Freddie for purchase in order to provide housing liquidity for this end of the market, to lower interest rates to home buyers, and to sustain the housing recovery. In my view, this argument is exaggerated. For discussion purposes, let's refer to jumbo loans as those over $108,000. Over the last year they have accounted for only 6 to 8 percent of the total mortgage loans originated.

Further, it takes an annual income over $59,000 to qualify on a standard $108,300 mortgage, that is, about a $114,000 house. Approximately only 5 percent of American families make greater than $60,000 per year. As the amount of the loan increases, logically so do the qualifying income requirements. Thus, we are not talking about individuals or families of meager means.

Even in high cost areas these are upwardly mobile wage earners able to shop around. Further, mortgage credit is available, albeit sometimes at a slightly higher rate. It simply is not accurate to argue that such loans are not available. Thus, I agree heartily with those who want liquidity in the jumbo market and high cost relief to the home buyer. However, in my view, S. 1821 and S. 1822 will provide this relief and I urge all interested parties to evaluate this rather carefully. Two years ago private sector alternatives did not exist. Now they do. Let's encourage this private market to grow, produce, and in so doing serve the home buyer in the higher brackets. If on the other hand, the agency's ceiling is lifted and, perhaps, they are empowered to sell TIM's securities, the private conduits

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are convinced, as I am, that Fannie and Freddie will by way of their agency status, dominate the jumbo market.

Let's not resort to a typical congressional response—"What we give with the right hand we take away with the left."

I would propose to the investment and housing industries that we move for rapid passage of mutually agreed upon forms of S. 1821 and S. 1822. Let's let the private market prove itself in this jumbo area. Let's let them innovate products, commit capital, and lower the cost to the home buyers in this small segment of the market. Our Nation would be better served all around if we were successful in attracting new billions of mortgage credit by this alternative.

After a defined period of time we can measure their success and determine if the private sector has taken up the slack in the market. In my view, we need to use common sense and good business judgment here. We could never clearly measure the effects of this important step if we were to approve additional congressional advantages for the Federal agencies in the jumbo market area.

Also, I would like to comment on the notion that private market players are fair-weather friends. The private sector will continue to find profitable opportunities in down cycles. This is primarily due to the fact that risk or exposure in issuing conduit securities is minimal. One is governed by spreads, not absolute rate swings. As Mr. Pope of General Electric Credit said yesterday, "The only thing at stake in a down cycle is not whether adequate capital is available, but instead whether the home buyer can afford the loan." And that is true for those mortgages purchased by Fannie Mae as well.

Today we have an impressive list of witnesses from the regulatory and business community. Our first witness is a gentleman who needs no introduction before a congressional committee. With his former chairmanship of the Federal Home Loan Bank Board when Freddie Mac had its beginnings and, in his current role at the Fed, we are pleased to hear the expert views of Preston Martin, the Vice Chairman of the Board of Governors of the Federal Reserve System.

Mr. Martin, we're delighted to have you today. We would ask you to confine your oral presentation to 5 minutes or so if that's possible, to submit a more complete statement for the record if you wish, and then submit to question by the committee.

Senator PROXMIRE. If the chairman would just yield for a minute, I'd just like to say——

Senator TOWER. I beg your pardon. Let me yield to Senator Proxmire and Senator Riegle.

Senator PROXMIRE. I just wanted to say that the chairman of this committee is in real trouble because I agree with what he just said. [Laughter.]

I'm sure that makes him very uncomfortable but I think he's made an excellent statement that makes a lot of sense.

Senator TOWER. We agreed once back in 1970, Bill.

Senator PROXMIRE. Well, we agreed once more recently than that. We both liked kittens. [Laughter.]

At any rate, my mind is as open as it can be on this and I do want to hear the other side. I didn't have a chance to hear the other side yesterday, but I think the chairman has made a very,

very persuasive case for not raising those ceilings and I thank him very much.

Senator TOWER. Senator Riegle.

Senator RIEGLE. I have no opening statement today, Mr. Chairman, but would join you in welcoming our witnesses.

Senator TOWER. Mr. Martin.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MARTIN. Thank you, Mr. Chairman. I will abbreviate my remarks and rely on the the chairman's generosity to insert my written statement in the record. I will proceed with some substantial leaps through my written testimony.

FUTURE OF HOME FINANCING

I appreciate the opportunity to be here. The secondary mortgage market has been a professional interest of mine for more years than I'll admit, considering the median age of the spectators here today, and I support the general thrust of these two measures, S. 1821 and S. 1822. As was testified yesterday and noted in the opening statements by members of the committee, the secondary markets and mortgage-backed securities are likely to be the predominant ways that housing will be financed in the years to come.

We can take some pride in the success of public policy over five decades or more and in the ability in this field, which is certainly not true in every field, to utilize private market mechanisms complemented by a variety of governmental aids and procedures. It is really that mixed economy, a mixture of private and public vehicles and mechanisms and procedures that has been successful.

The current shift in thinking on the part of many in Congress, and in the regulatory community, with regard to the functions, the assets and the liabilities of financial institutions, of course, underlines the importance of this consideration today.

We have had more than a decade of experience with conventional mortgage-backed securities. We know much more now than we did just a few years ago, and as the chairman mentioned, the so-called jumbo loan, forming the pools of mortgages behind securities, is one more bit of evidence that we can utilize.

I have been involved in the Federal sponsorship kind of agency as well as a private issuer of this kind of security, and I certainly support the efforts outlined in the two bills to further the private side of this process.

The ultimate beneficiary is going to be a family or individual buying a home or condominium or a co-op. We have had a little slippage in the home ownership rate in this country, somewhat in contrast to some foreign countries where they have made some institutional changes to promote homeownership. For example, the British now have a 60-percent home ownership rate because of their practice of permitting occupants to buy council houses—local government-provided housing. Yet here we are for the first time since the Great Depressison with a little bit of decrease in our homeownership rate. And thus you are so right in giving another look at how we are financing housing. No reflection on my home builder friends, but the old builder slogan is, "I build anything I can finance." And, of course, we Americans tend to buy anything that we can get the lender to qualify, as the latest savings rate on personal disposable income has indicated.

So it is most important to look at conventional lending and to broaden and deepen the secondary market, both for mortgages and for mortgage-backed securities.

POOLING MORTGAGES AND ISSUING SECURITIES

I would like to turn to page 5 in my testimony. Previous witnesses before this distinguished body have rightly pointed out that the anachronisms in State law regarding the qualification of mortgage-backed securities arise not because some State legislators several decades ago didn't like those instruments; nobody even thought there ever could be such a thing. As we know, it's only been this last decade that these creatures have existed in the capital markets. I can remember going up and down Wall Street talking about mortgage-backed securities, and the glazed look that would suffuse the face of each of the Wall Streeters when we started talking about pooling mortgages and issuing securities. Today, of course, this is a successful and growing operation. However, I'm not one to generally endorse the preempting of State law. I used to be a State governmental official, and it seems to me that the government that's close to the electorate oftentimes has a view and perception and awareness that some of us in the Nation's Capital have trouble hanging onto.

Senator TOWER. Very diplomatically stated.

Mr. MARTIN. Thank you, sir. I could have quoted Senator Tower with regard to certain aspects of this perspective, but I refrained from doing that.

So I support those laws on the preemption, but only reluctantly. I also feel that the so-called technical amendments in title I of S. 1821 that would remove statutory limitations on investments in this kind of security by federally chartered financial institutions are an obvious move in the right direction.

We are aware of the current legal constrictions on national banks—you know, the old-fashioned look at pass-through securities as obligations of the issuer, when they already have a bank guarantee or private mortgage insurance, and mortgage pool insurance. In that case, it certainly is not the issuer who is on the line.

Obviously, going past purely technical amendments into areas where there may be competing policy objectives, I have some concerns; as indicated at the bottom of page 6. As we greatly change some of the protections of investors and savers, we have to proceed with great care.

At the Federal Reserve we were aware of this consideration when amending several of our regulations, and we applauded the SEC's recent technical charges to registration requirements. But there's often a question of appropriate criteria. For instance, how does one monitor the quality standards for the mortgages pooled? There are many strange animals that go under the title of mortgage. As we know, the lending and building community have been very ingenious lately in developing all kinds of new mortgages—

shared equity loans and a number of other alternatives that are complicated and hard for the home buyer to understand, in the first place, and even difficult for the lending officer to understand in many cases.

So quality standards are something on which I know you will concentrate. I think this is particularly true when you get into the Federal preemption of State law. The term "investment grade" has been used in that context, and I'm not sure that's strict enough. "Investment grade," as I understand it, goes down to BBB, which could apply to mortgage securities with little or no equity in effect. Thus it seems to me that we really should be talking about the two top investment grades here.

I also have some problems when we get closer to some of the matters where financial industry regulators such as the Federal Reserve have more direct responsibility. Specifically, the Fed has some problem any time you start talking about national banks underwriting and dealing in private securities. I would be a little uncomfortable on that section.

I personally recognize that mortgage backed securities are different from corporate bonds. Certainly, commercial banks' mortgage loan departments have the capability to underwrite the mortgages. They can go back over the mortgage that they themselves originated or that was originated by someone else, reunderwrite it, and evaluate the risk. They're certainly capable of doing that, just as they're capable of originating their own loans.

Concerning S. 1822, the trust for investment in mortgages [TIM's] is a good move to get away from the grantor trust. I certainly support that. I would hope that the committee would be sensitive to the need for thrift institutions to issue these mortgage-backed securities against old low-rate loans, and consider the initial discount which might be earned on these securities.

Well, in summation, Mr. Chairman, I applaud your efforts in this context. I hope that there will be attention to quality standards, and I recognize that some provisions of the bills could cause some inconvenience to the management of Fannie Mae and the management of Freddie Mac. I happen to know those people pretty well. I think those organizations represent two very strong management teams and I believe that they can compete with a lot of private rivals even if they come from the General Electrics of the world. I'm not worried about the viability of those two sponsored enterprises.

So I applaud your thrust to provide them with some additional competitors and to widen and deepen the market for mortgage backed securities in the secondary market for the mortgages themselves.

Thank you for your attention.

[Complete statement follows:]

Statement by

Preston Martin

Vice Chairman, Board of Governors of the Federal Reserve System

Mr. Chairman and Members of the Committee, I appreciate the opportunity to present my personal views on the general thrust of Senate 1821 and 1822, bills that are designed to widen and deepen the secondary mortgage market of this nation. The Committee knows the importance of enhancing the growth of this already enormous source of funding for housing. Fundamental involvement in housing finance has been, on balance, a successful public policy spanning five decades or more. I believe an important aspect of that success has been heavy reliance on private institutions and market processes. Permit me to admit my pride in my own involvement in the Federal Home Loan Bank System's expansion of its credit facilities in the 1970s as well as the part I played in the founding and initial operating policies of the Federal Home Loan Mortgage Corporation, with Chairman Thomas Bomar.

The very success of public policy in the utilization of market processes to further homeownership and residential financing provides the platform from which private market initiatives can and should now be launched. Thirteen years ago my associates and I came before this Committee to advocate the establishment of a secondary market facility for conventional mortgage loans. Our plea then to Chairman Sparkman, Senator Proxmire and others was to obtain authority to demonstrate the feasibility of the conventional mortgage backed security, but we predicted at that time that the private market eventually could and would take over the function. I believe the time has now arrived for that transfer to be stimulated, while at the same time recognizing the outstanding accomplishments of both Fannie Mae and Freddie Mac, and their present strong leadership. The ability of both of these organizations to finance at rates not far from comparable maturity Treasury securities exemplifies the size, presence and position they have attained in the capital markets. I am confident that both organizations would continue to compete effectively with stronger private rivals.

The conventional mortgage backed security has proven its worth in the credit markets, even during the most recent recession that saw severely depressed housing conditions and falling house prices in some submarkets. Mortgage pools of high quality have been found repeatedly and recently to be safe investments, and the securities have involved credit risk insurance and other arrangements to protect investors and maintain cash flow. It seems to me that the record supports the objectives and thrust of the legislation which is the subject of this hearing.

The growth of secondary mortgage market activity, of course, has been very substantial since the late 1960s. Furthermore, the need for secondary market channels is likely to increase in the future, to the extent that some thrift institutions utilize the expanded asset powers recently provided to them by law and regulation. To better match the duration and interest rate sensitivity of assets with liabilities, some thrifts and other mortgage originators may move more and more mortgages to investors through the secondary markets. Of course, another constructive option open to them in this regard would be to promote and invest in more variable-rate mortgage instruments.

Pass-through securities are relatively new and effective secondary market vehicles that attract a wide variety of capital market investors into mortgage instruments. Since the early 1970s, the thrust of public policy has been to encourage development and growth of markets for securities guaranteed by federal agencies and federally sponsored enterprises. By the middle of this year, pass-throughs guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Federal National Mortgage Association totaled $211 billion--equivalent to a sixth of all residential mortgage debt outstanding. GNMA securities, issued exclusively against pools of federally insured or guaranteed mortgages, account for two-thirds of all federally guaranteed pass-throughs outstanding. But the volume of FHLMC and FNMA securities, issued primarily against pools of conventional loans, has been expanding very rapidly since late 1981. The managements of those entities have helped to fill a mortgage credit gap during a critical financial adjustment period.

By contrast, development of markets for fully private mortgage pass-through securities--that is, securities without federal sponsorship issued against pools of conventional loans--has been quite modest. While a fair number of banks, thrift institutions, mortgage companies, insurance companies and so-called conduit organizations have issued private pass-throughs, available estimates suggest that the total amount outstanding is less than $10 billion.

In my judgment, it would be sound public policy to change laws and regulations, where appropriate, to encourage a broadening of the secondary mortgage market through more extensive involvement of the private sector. The President's Commission on Housing, on which I served as a member before being appointed to the Federal Reserve Board, identified a host of legal and regulatory impediments to development of the private mortgage securities markets in its 1982 report. As you noted when introducing S.1821 and S.1822, components of these legislative proposals attempt to crystalize Housing Commission recommendations for encouragement of private securities as well as to formalize the "TIMs" proposal that grew out of the Commission's work.

As you also noted when introducing this legislation, a comprehensive look at both private and public secondary market institutions is in order. It is obvious that federal policy toward the two sponsored enterprises, FNMA and FHLMC, will help determine the competitive position of private mortgage-related securities in the conventional mortgage market and in the nation's capital markets. As a general principle, I am fully in favor of improving the efficiency of private financial markets and reducing reliance on the government's presence in the credit system, as long as these objectives can be achieved without seriously compromising other legitimate social and economic goals. As these hearing have amply demonstrated, difficult questions concerning the proper balance of public policy and tradeoffs of competing objectives inevitably arise in this context.

I will concentrate the balance of my remarks on two topics. First, the types of legal and regulatory adjustments appropriate to bolster development of the private securities markets--the major focus of the legislation you have introduced. Second, possible government policy toward the federally sponsored secondary mortgage market enterprises. In the latter area, my comments necessarily will be broad and suggestive since no specific legislative proposals are extant.

Private Mortgage-related Securities

Laws and regulations that have unfairly disadvantaged the competitive position of private mortgage securities in our financial markets do not constitute good public policy, and should be modified. In this regard, I'm talking about inadvertent, or unintended, constraints and obstacles for the issuer of private securities. At the Housing Commission, we determined that there have been a number of such constraints, sometimes caused by state or federal laws or regulations written long before mortgage-related securities were a significant market factor, or arising because of inadequate understanding by lawmakers or regulators of the nature of mortgage securities.

Some of these constraints recently have been alleviated by regulatory changes at the federal level, in line with Housing Commission recommendations. For example, the SEC has tailored some of its registration requirements to the special characteristics of both the private mortgage pass-through securities and the issuers of these types of securities. At the Federal Reserve Board, we have amended Regulation T--which governs margin credit extended by brokers and dealers for the purpose of purchasing or carrying securities--to specify that private mortgage-backed securities are eligible collateral for such credit. We also have tailored the Regulation T criterion concerning marketability of securities in margin accounts to fit special features of the mortgage instruments.

Some components of Title I of S.1821 also constitute technical amendments designed to accommodate properly private mortgage securities. I am referring to such things as the removal of statutory limitations on investment in mortgage-related securities by federally chartered financial institutions, leaving it up to the regulators to specify investment limits as well as factors relating to the diversity of underlying mortgage pools. The law for national banks, in effect, currently treats mortgage pass-through securities as obligations of the issuer or sponsor rather than as shares in pools of loans constituting the obligations of mortgage borrowers. The current treatment is a good example of law that does not recognize the true nature of mortgage pass-through securities.

Some components of Title I of S.1821 obviously go beyond the types of technical adjustment to law and regulation I have been discussing and may involve some tradeoffs of policy objectives that need to be considered carefully. Caution should be exercised whenever federal or state laws or regulations, designed to protect savers, investors or financial institutions, are amended, or preempted, in order to accommodate the development of a particular market.

It appears that investor protection conceivably could be compromised, for example, if the SEC registration exemption currently available to financial institutions supervised and examined by state or federal regulators were extended to any HUD-approved mortgagee. The integrity of today's mortgage banking industry is not in question. But mortgage bankers basically are unregulated institutions, and consideration should be given to ways to set and monitor quality standards for mortgages "pooled." I would hate to see isolated problems in the future undermine development of the private mortgage securities market.

The provision of S.1821 that would involve federal preemption of state blue-sky and legal-investment laws and regulations for all investment grade mortgage-related securities, subject to reversal by the states within two years, raises further questions about investor protection as well as the interests of savers in state-chartered depository institutions, life insurance companies and pension funds. As I understand the term, "investment grade" is not a particularly strict standard, and commonly is interpreted to cover the top four categories used by the nationally recognized rating firms--extending down to BBB under Standard and Poor's designations. Most public offerings of private mortgage pass-through securities, in fact, have been rated in the top two categories, and it may be questionable public policy to require the states to treat all investment grade issues as if they were Treasury or agency securities.

On a subject closer to the Federal Reserve, I would like to raise some questions about the provision that would grant authority for national banks to underwrite and deal in private mortgage-related securities. The Federal Reserve has been concerned that underwriting private securities, particularly corporate bonds, could involve unusual elements of risk for banks and possibly could lead to conflicts of interest in the provision of credit.

Though equivalent risks presumably would not arise in the pass-through securities markets--banks already have the authority to underwrite issues guaranteed by GNMA, FNMA and FHLMC--it is an area that should receive some consideration in this legislative process.

Concerning S.1822, a bill that would establish a new type of mortgage investment trust under the tax code, I can enthusiastically support the effort to create more flexible trust devices that would retain the flow-through federal income tax features critical to pass-through securities markets. The Housing Commission had discussed the need for new types of trust devices for issuers of mortgage-related securities, as alternatives to the so-called "grantor trust" currently used for virtually all pass-through issues. As I see it, the major objectives of the effort to establish new trust devices should be to permit issuance of different classes of securities against a mortgage pool and to allow some degree of management of assets and cash flows by the trustee. Such features could be used to tailor issues to the maturity and cash-flow preferences of different types of investors and could result in more advantageous pricing of pool securities--thus leading to lower mortgage rates for consumers. Thrift institution issuers, for example, would have the opportunity to market the longer term classes and retain the shorter term securities, aiding their adjustment of liabilities and assets into a better maturity balance.

I am not prepared at this time to testify on the many technical aspects in S.1822. One thing missing in that bill, however, is reference either to quality standards for the "TIM" securities or to supervision of the trustees or managers of TIMs. At the Housing Commission, we considered the need for minimum quality criteria for new types of mortgage trust vehicles, in order to promote standardization in the private securities market and to obtain favorable treatment of securities by the Department of Labor (for private pension funds) and possibly by state regulators (for fiduciaries under their jurisdiction). I am concerned that creation of new types of mortgage investment trusts, that apparently could take a variety of forms (corporate or otherwise) under S.1822, and that would permit trustees to actively manage the funds entrusted to them by individual investors, would create leeway for bad reinvestment decisions or even for abusive practices by trustees or managers. Such events, of course, could heavily damage all elements of the private mortgage pass-through securities market.

It's difficult to specify, at this time, the type of supervisory structure within which TIMs ideally should operate. One possibility would be to require that TIMs be subject to the types of controls established for mutual funds registered under the Investment Company Act of 1940--other entities with flow-through tax treatment under the Internal Revenue Code. Another possibility would be to involve federal agencies with considerable expertise in housing finance, such as the Federal Home Loan Bank Board, in the supervisory process.

Federally Sponsored Credit Agencies

The federally sponsored secondary market enterprises certainly have performed important functions quite well, introducing new types of secondary market instruments and developing channels between conventional mortgage borrowers and a wide range of capital market investors. A little over a decade ago, such channels were virtually nonexistent and, as you know, I was directly involved in the establishment of FHLMC as a secondary market facility for conventional mortgages. Both FNMA and FHLMC have done pathbreaking work by helping to standardize the conventional home mortgage instrument and by moving large amounts of pass-through securities issued against pools of such loans into a capital market unaccustomed to conventional pass-throughs.

We have now reached a point where conventional mortgage documents are standardized nationally, where mortgage pass-through securities are a familiar instrument in national financial markets, and where the private mortgage insurance industry is capable of providing mortgage pool insurance necessary to secure high ratings for a large volume of conventional pass-throughs. Should we, therefore, conclude that the federally sponsored secondary market agencies have completed their job? Is it time to remove whatever legal and regulatory elements have been impeding development of the private market--the intent of S.1821 and S.1822--and at the same time sever the federal connections of FNMA and FHLMC?

As a general principle, it seems obvious to me that the use of federal enterprise status, and the special advantages that go with this status, should be reserved for those activities that are not, or cannot be, performed adequately by the private sector. It may be possible for the private sector to develop a large and efficient market for mortgage-related securities that would provide mortgage borrowers ready access to funds in the broad capital market structure at competitive prices--your legislative proposals are aimed in this direction. But as a former issuer of private mortgage-backed securities, it is not clear to me that fully private securities will be able to compete successfully, head to head, with federally guaranteed instruments, even if the legislative package you have introduced should become law. To date, private securities have been successful mainly in the market space left by FNMA and FHLMC. Most issues have been private placements tailored to individual investors or public offerings issued against pools of loans larger than those that can be purchased by the federally sponsored enterprises.

Although it is possible to argue for a phase-down of the federal connections of FNMA and FHLMC--in concert with development of viable private sector alternatives--it should also be recognized that the federally sponsored enterprises can provide some public benefits that cannot be provided by private alternatives. In particular, these enterprises are in a position to funnel the benefits of their federal connections to mortgage borrowers. Thus, one policy option is to ensure that the benefits accrue to borrowers most in need of aid, as identified through the political process. This approach would seek to target the mortgage securities programs of FNMA and FHLMC, in terms of criteria such as maximum loan size or borrower income.

If Congress decides that privatization of one or both of the sponsored enterprises is the appropriate policy objective over the long term, some transition problems will have to be faced. For one thing, the rights of holders of outstanding stock, debt, and guaranteed pass-through securities would have to be protected. And, of course, it would be unwise to sever federal connections unless the sponsored enterprises could function effectively on their own. The Federal Home Loan Mortgage Corporation currently is in a healthy financial condition. But more difficult transition issues would be raised with the Federal National Mortgage Association because of its large portfolio of mortgages having interest rates below current market levels.

As a final point, I would like to remind the subcommittee that housing finance is likely to be the first casualty in any future "crowding out" of private financing occasioned by the huge structural federal deficits that are on the horizon. It would be unfortunate, indeed, if this problem were compounded by inefficient market mechanisms. As pointed out in the Report of the President's Commission on Housing (p. 116), "Since the mid-1960s, the ability of the housing finance system to meet the needs of borrowers has deteriorated markedly on several occasions, and this system currently is in a serious state of disrepair. The volume of residential mortgage lending naturally reflects changes in financial market conditions because the sensitivity of demand for mortgage credit to changes in interest rates is high relative to interest rate sensitivity in other major sectors of the economy. However, the increasingly wide swings in residential mortgage and housing construction activity also are traceable to structural shortcomings in the housing finance system."

Senator TOWER. Thank you, Mr. Martin.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Martin, on page 10 of your testimony you state that, "Housing finance is likely to be the first casualty in any future 'crowding out' of private financing occasioned by the huge structural Federal deficits that are on the horizon." It is important that you made this point and I do agree with you.

Mr. MARTIN. Yes, sir.

Senator RIEGLE. And you state further that it would be unwise to sever Federal connections unless the sponsored enterprises, Fannie Mae and Freddie Mac, function effectively on their own.

PRIVATE SECTOR TIMEFRAME

How long do you think it will take the private sector to develop, in your words, "a large efficient market for mortgage related securities that would provide mortgage borrowers ready access funds in the broad capital market structure at competitive prices?" What timeframe are you envisioning here?

Mr. MARTIN. Senator Riegle, I think this process will require quite an extensive period of time. A company with which I was once affiliated issued the first public issue of conventional mortgage backed passthroughs in 1979. That company, despite a considerable effort since that period, has come up with about $400 million worth of those securities, even with very strong financial backing and some knowledge of the markets.

If S. 1821 and S. 1822 are passed, I think what you will see is the market share that the private issuers can capture will increase quite a bit. However, I think over the next 5 years Fannie Mae and Freddie Mac will be vital to the market, and to home buyers in this country, and will continue to dominate. I think they can gradually be dislodged. I must say I don't think that this is the last time this committee will consider the subject. These are good steps in the right direction. But as we learn more about the private issuer you'll probably be back again on this subject.

Senator RIEGLE. Let me just press a little harder because you have made a very important point about developing a large and efficient market for mortgage-related securities that would provide mortgage borrowers ready access to funds in the broad capital market structure at competitive prices.

Is it likely to be 5 years away, a decade away or even longer?

Mr. MARTIN. Let me be more quantitative, then, I think that's where you're leading me.

From 1979 to 1983 this private side of the secondary market, the MBS issuance, has grown considerably, so that now they'll run $8 billion against $200 billion for Ginnie Mae and Fannie Mae and Freddie Mac—of course, Ginnie Mae is a whole different story. If they can do that in a few years against many obstacles, I don't think it will take forever. Forecasting, of course, is easy and always wrong, but I think after 5 years you will be back examining the related issues of the future status of Freddie Mac and Fannie Mae. I think that's a reasonable time horizon.

Senator RIEGLE. Five years from now how much of the secondary mortgage market will the private sector have?

Mr. MARTIN. I think you'll have the private market at 10 or 15 percent of the market then and we'll know a lot more about what we could do to get them moving on out to considerably larger shares.

Senator RIEGLE. Maybe 10 to 15 percent of the market over a 5-year period?

Mr. MARTIN. Yes, sir; and that is an enormous amount of funds. We're not just talking about a billion here and a billion there.

Senator RIEGLE. Some have suggested that the private market will not develop properly unless Fannie Mae and Freddie Mac are essentially frozen in their current form. Do you agree with that?

Mr. MARTIN. I wouldn't freeze anybody—let's look back to June when Freddie Mac came to market with their CMO, a new instrument with three different maturities. But I would suggest again, in response, that we give as many advantages as we can to the private sector, but let Fannie and Freddie continue to experiment.

Senator RIEGLE. If there were adjustments made for certain high-cost areas above the current $108,300 limit, do you think that would be a material disincentive to the normal development and activity of the private side here?

Mr. MARTIN. I don't think it would be a material disincentive, but why do it? Here's an area where the private sector is coming in and filling the gap. I'm very sympathetic with my old friends in those two agencies, but let's get some more rivals out on the stage.

Senator RIEGLE. That's all for me at this point, Mr. Chairman.

Senator TOWER. Senator Gorton.

Senator GORTON. What's your opinion of the current adequacy of the private secondary-mortgage market in the field of mortgages above $108,000? Do you think we need to expand the limits of Freddie Mac and Fannie Mae?

Mr. MARTIN. I couldn't hear the last part.

Senator GORTON. Do you feel that we need to expand the purchase limits of Freddie Mac and Fannie Mae or is the private sector adquate?

Mr. MARTIN. No, sir; I don't think we should increase those ceilings. On the other hand, there may be other technical changes that would advantage Fannie Mae or Freddie Mac still operating under those ceilings that would be called for, and they have submitted to this committee various proposals which I'm not in a position to testify on.

Senator GORTON. If the Congress fails to pass either of the bills that we're dealing with today, will federally chartered agencies be able to meet the demand for mortgage credit in the foreseeable future?

Mr. MARTIN. I don't think so. Not at rates which Americans can afford.

Senator GORTON. So you think that these two bills are vital?

Mr. MARTIN. I think the thrust of the two bills is vital and I understand that one of the purposes of the hearing is to put flesh on the bones, as it were. I certainly would applaud that. It's a very good first step.

INTERFERENCE WITH TRADITIONAL STATE POLICIES

Senator GORTON. On another but related subject, S. 1821 includes a Federal preemption of State blue sky and investment laws and regulations which limit the present sale of mortgage-backed securities. Although there's an opt-out provision for States, what is your view of that further interference in what has traditionally been an area in which States have had full authority to set their own policies?

Mr. MARTIN. I regret that the State legislatures have not responded in this area on their own, but they have not. Some of the very States which face the largest mortgage credit gap in the future, have not acted, although hearings of this sort have not occurred very often. So I think it's time for national preemption, as much as I dislike that technique.

Senator GORTON. So the States have a right to be right but not a right to be wrong?

Mr. MARTIN. Well, you give them 2 years to overturn it. That's an escape hatch.

Senator GORTON. Thank you, Mr. Chairman.

Senator TOWER. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, I want to congratulate you on having this witness appear. I can't think of anybody who would be better qualified. He was a distinguished Chairman of the Home Loan Bank Board. You started up your own company called PMI. I assume that stands for Preston Martin Insurance or private motgage insurance, whatever you want to call it. You also worked, as I understand it, for Sears and I'm not sure, but did you start their secondary mortgage operations?

Mr. MARTIN. Yes, sir. That's correct.

Senator PROXMIRE. And, of course, now you're Vice Chairman of the Federal Reserve Board. So you have exactly the kind of qualifications and background that can be helpful to us.

I notice that you put a lot of stress on page 6 in your statement on being a little cautious here. You say:

> It appears that investor protection conceivably could be compromised, for example, if the SEC registration exemption currently available to financial institutions supervised and examined by state or federal regulators were extended to any HUD-approved mortgagee.

Then, you also talk about the Federal preemption of State blue sky and legal investment laws and caution us on that.

Could you suggest language that would provide whatever protection you might deem would be helpful to make sure that we don't go off the deep end? You say, you think it would be unfortunate if we pass legislation that can embarrass or compromise this effort.

Mr. MARTIN. Yes, sir.

Senator PROXMIRE. So would you suggest language to us?

Mr. MARTIN. Yes, sir. I would be glad to, Senator Proxmire.

Senator PROXMIRE. And finally, you say farther down on that page, "some questions about the provision that would grant authority for national banks to underwrite and deal in private mortgage-related securities," and you go on to say, "The Federal Reserve has been concerned that underwriting private securities, particularly corporate bonds, could involve unusual elements of risk for banks and possibly could lead to conflicts of interest in the provision of credit. Though equivalent risks presumably would not arise in the pass-through securities markets, it is an area that should receive some consideration in this legislative process."

How can we provide that consideration? Can you again suggest language or suggest some kind of amendment that we might consider?

Mr. MARTIN. Yes, I will.

Senator PROXMIRE. Will you do that?

Mr. MARTIN. Yes, sir.

[Information subsequently supplied for the record follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

October 5, 1983

PRESTON MARTIN
VICE CHAIRMAN

The Honorable William Proxmire
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

I appreciated the opportunity of testifying before your Committee, on my own behalf, on S. 1821 and S. 1822 last September 22, 1983. These bills have as their purpose the enhancement of the secondary market for mortgages and simplification of the use of mortgage-backed securities to accomplish that enhancement--general objectives that I strongly endorse.

During that testimony, I expressed concern about two provisions contained in S. 1821 and reservations about a third. The objects of my concern were the provisions that would exempt HUD-approved mortgagees from registration under the Securities Act of 1933, even if these lenders are not regulated by a federal or state agency, and that would preempt state "Blue Sky" and legal investment laws. I had reservations, but did not oppose, the provision that would permit national banks to underwrite and deal in private mortgage-backed securities. After my testimony, you asked whether I would suggest language for consideration by your Committee that would address the concerns I expressed. I offer the following comments in response to your request, again speaking on my own behalf.

Subsequent to my testimony, your office furnished me with a revised version of S. 1821 which I understand will be considered during a mark-up session on Thursday, October 6th. The revised version of the bill contains changes that address, to a large extent, the concerns I expressed in my testimony. I particularly note that the provision pertaining to permissible national bank transactions in private mortgage-backed securities no longer includes an amendment to section 5136 of the Revised Statutes (12 U.S.C. § 24, Seventh) permitting a national bank to underwrite and deal in the securities.

With regard to the provision preempting state Blue Sky laws and legal investment statutes, I note that the revised bill allows three years for a state to opt out of the federal preemption. While this change goes some distance in addressing the concerns I expressed in my testimony, I would like to add that it might even be appropriate to leave the option of overriding the federal preemption open-ended. We cannot say with any certainty at this time that local, regional, or statewide economic conditions might not deteriorate in such a manner that the state may feel it is appropriate to apply more stringent legal investment standards than federal law would permit or to require more complete disclosure with respect to the character of the underlying collateral.

The bill attempts to protect the investor by incorporating in section 101, which would amend section 4(5) of the Securities Act of 1933, mortgage-backed securities rated by a nationally recognized statistical rating organization in one of the top four rating categories. In response to a question during my testimony, I suggested using the top two categories. Upon further reflection, I have two observations to make on the use of private rating services in this context. First, Congress is depending upon private rating organizations to set market standards. There is no assurance that these organizations will retain their current rating schemes or will not adjust their rating categories in a manner inconsistent with the risk levels anticipated by Congress. Second, while the bill is designed to allow sophisticated investors to purchase mortgage-backed securities, the investors include fiduciaries, such as pension plans and investment trusts, that act on behalf of small investors. Those small investors may wish to know the character of the investments that their legal agent is acquiring.

Thus, I believe that allowing the states an unlimited amount of time to override federal preemption of their Blue Sky and legal investment statutes, should special economic circumstances dictate such action, is preferable to incorporating private rating service standards in federal law. Should the latter approach be adopted by Congress, however, I would suggest using the top two investment grades, rather than the top four, as the standard.

With respect to the exemption of HUD-approved mortgagees from registration as currently provided in section 101 of the revised bill, I continue to believe that unregulated mortgage lenders that sell securities to the general public should continue to be covered by the Securities Act of 1933. Depository institutions are subject to substantial supervision, regulation, and examination which accomplish many of the same objectives as registration and securities disclosures. Exempting nonregulated institutions from registration and disclosure requirements increases the potential risk that an issuer could be less than forthcoming with investors with respect to the quality and character of the underlying mortgage pool. For this reason, I would suggest changing that portion of section 101, which would amend section 4(5)(B) of the 1933 Act, by deleting the following language:

> . . . or were originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to section 203 and 211 of the National Housing Act . . .

If you need further information from me on this matter, please do not hesitate to contact me.

Sincerely,

/s/ Preston Martin

Preston Martin

Senator **Proxmire**. Thank you, Mr. Chairman.

Senator **Tower**. Mr. Martin, you mentioned the purchase of council houses in Britain. In fact, that was a major issue in the last general election campaign in Britain and the party responsible for initiating sale of council houses to the tenants prevailed very handsomely, I might add. We have traditionally taken a bipartisan approach on housing issues in this committee. There have been exceptions, but I think over the years the record will show that this committee has stood fairly closely together on a bipartisan basis on housing issues and I hope that we will do so in this particular instance.

One historical note that also occurs to me that I think Senator Proxmire, who is the only one here with a longer corporate memory than mine, would agree that we very often started out to devise housing programs to make housing available to low-income families and somehow they keep drifting up to the point where the primary beneficiaries become middle-income families.

Mr. **Martin**. Right.

Senator **Tower**. One thing that occurs to me is if we raise the limits of Fannie Mae and Freddie Mac that there will be a tendency for them to invest in the jumbo mortgages, the higher ones, possibly at the expense of available funds to the lower-income families seeking housing. Is that a valid observation?

Mr. **Martin**. I think that's a possibility.

Senator **Tower**. It occurs to me that with finite resources available to Fannie Mae and Freddie Mac it would be my hope that there would be no paucity of supply of funding for housing for the moderate and lower incomes.

Some have questioned whether or not it's appropriate in S. 1821 to allow depository institutions to underwrite and issue mortgage backed securities. Would you comment further on this issue, given the current effort by both the Congress and the regulators to move toward a level playing field of competition?

DANGER OF CONFLICT OF INTEREST

Mr. **Martin**. Yes, sir. I feel that there is some danger of conflict of interest when a financial institution has a mortgage backed securities department and management says to the fellow running that function, "Now this is your goal for this year. You're going to issue $100 million worth of these securities. That's what we want you to do in this institution." Then he is liable to drift over to the mortgage lending people and say, "Gee, they've really got me over a barrel here. I've got to get $100 million worth of these things. Can you help me." So you begin to have this kind of a conflict.

But if the quality standards are high enough for the mortgages that go into the pool, this would tend to obviate the problem because that same fellow is going to have to go out and buy other mortgage originators' loans to meet his quota. The very nature of buying the other institutions mortgages provides the protection that you have to a lesser degree when you're underwriting corporate securities. The institution may be making loans to a corporation and then underwriting its securities—a question of what happens to the credit judgment. Do you tend to be a little swayed because your colleague in the securities issuance department is counting on that company getting the credit and being able to operate? Much less of this is evident in considering mortgage by mortgage.

Senator TOWER. Mr. Martin, based on your long familiarity with the study of these issues, in your opinion, how could Fannie Mae best continue to make substantial improvements and progress in their portfolio? I might add further, should they continue to rely so heavily on portfolio lending?

Mr. MARTIN. Well, I think the progress Fannie Mae has accomplished in the last few years has been nothing short of remarkable. I know the people there and from time to time I talk with them about their policies, and they are very polite. I'm not sure how much impact I ever had there. I think they're doing the right thing and pursuing the right course now, but it's going to take some time, as Senator Riegle was implying in his question line.

SEC REGISTRATION EXEMPTION

Senator RIEGLE. I just wanted to follow up on something that Senator Proxmire raised. On page 6 of your testimony you raise the issue of SEC registration exemption. You point out, and I agree, that the integrity of today's mortgage banking industry is well established.

But you have expressed concern that problems could arise with exemption from SEC registration and I'm just wondering what is it that you think could happen? What are the risks involved in monitoring the development of these securities?

Mr. MARTIN. Well, there are so many thousands of participants in the mortgage origination business. The criteria for HUD-approved mortgages basically includes a rather minimal capital requirement along with some operating standards and financial reporting to HUD. I don't have any problem with that, but when you get to issuing mortgage backed securities at $10 million or $25 million at a crack, and Wall Street is going to pressure these people to issue large amounts, problems may crop up. They're going to say, "Well, you don't want to do $10 million. That's too small and no secondary securities market"—and then you get a firm with a $250,000 net worth scrambling around to do a $25 million MBS issue. It seems to me you've got to have a much greater degree of supervision and regulation to justify an exemption from SEC registration and disclosure requirements when an issuer may be selling these securities to the general public.

Senator **Riegle**. What are the risks if we are not more diligent in that respect?

Mr. **Martin**. The smaller firm with less experience in the market will reach to get enough mortgages to build the pool up to get a $10 million issue or a $25 million issue or a $50 million issue. There is a lot of talk on Wall Street that you've got to get $50 million worth of these things together, and it's inevitable that there could be some instances in which the quality of the mortgages is really not very good.

Senator **Riegle**. So we could eventually have a default in this situation which could put a cloud over the development of the market?

Mr. **Martin**. Yes, sir.

Senator **Riegle**. Thank you.

Senator **Tower**. Any further questions of the witness?

[No response.]

Senator **Tower**. Mr. Martin, thank you very much. It's been very useful testimony. Our next witnesses constitute a panel. Our panel this morning consists of Mr. Lewis S. Ranieri, managing director, Salomon Brothers Inc, New York; Mr. Richard T. Pratt, president, Merrill Lynch Mortgage Capital, Inc., New York—Mr. Pratt, I might add, is also the former chairman of the Federal Home Loan Bank Board; Mr. Laurence D. Fink, managing director, the First Boston Corp., New York; and Mr. Phillip C. Scott, partner, Goldman Sachs & Co., New York.

Gentlemen, we are delighted to have you this morning. I'm reluctant to do so but I must advise you that because of our time constraints we will ask you to confine your oral presentation to 5 minutes each and submit whatever additional material you like for the record. You may submit a more complete statement for the record and it will be incorporated fully in the record, but if you could summarize it in 5 minutes we would be grateful because we do want to have adequate time for questions. So we will first call on Mr. Ranieri.

STATEMENT OF LEWIS S. RANIERI, MANAGING DIRECTOR, SALOMON BROTHERS INC, NEW YORK, N.Y.

Mr. **Ranieri**. First, let me thank you for having us here. I would like to submit my written presentation for the record and summarize it very briefly.

Basically, Mr. Chairman, the thrifts' funded housing, the agencies simply acted on the periphery of housing, serving primarily the lower end of the moderate income housing area, and there was no significant private sector participation.

Once the thrifts became disintermediated they could not fund housing to the same extent and in the same way. We all universally developed this notion that the capital markets would consequently be called on to bear a greater share of the funding of housing. That was an interesting notion, Mr. Chairman, but practically unfeasible.

All of the capital markets, whether it be the corporate bond market, the government market, or the municipal market, grew up slowly over time with the safety net of supporting regulation, charter, and precedent which enabled them to operate. That was not the case for the private mortgage securities market because no one envisioned its existence prior to the need for its creation.

The agencies, on the other hand, were armed with their agency exemptions which got around all of the peculiar problems that mortgages have had in accessing the capital market. They therefore moved from the periphery of housing finance to much more the center and filled the breach by acting as the conduits between the mortgage market and the capital market. Their success in this role has been largely because of their exemption as much as because of their implied status as Government credits.

PRIVATE MORTGAGE SECURITIES MARKET

As you know, there's some fairly significant credits in the private sector as well. But, frankly, there was no private mortgage securities market prior to let's say 1979, although Salomon Brothers, along with the Bank of America, developed the first private mortgage passthrough security in 1977. The reason it didn't exist is because it could not exist. I remember our frustration as late as 1980 when we found that only 15 of 50 State funds could invest in an AAA-rated mortgage pass through security for the Bank of America and that the ERISA problems were so confused that virtually no private pension funds would be bothered with them. Further, this issue was not a legal investment for virtually any insurance company. To this day, we cannot trade private mortgage securities for forward delivery, which is the basic essence of the way the housing market acts and in fact the way the Ginnie Mae, Fannie Mae, and Freddie Mac mortgage securities are traded.

So the lack of the private sector was not one of desire but one of ability to perform.

We have made significant progress and as that progress has occurred, the private sector has become more active in response, but we are still very severely limited.

In listening to the previous speaker congratulate all of us collectively on our successes in the mortgage securities market, I caution you that these successes have largely been those of the government agencies. Private sector participation in the mortgage securities market is still at a very embryonic stage, facing very severe handicaps.

This bill will, largely for the first time, give the private sector the practical business ability to operate in the mortgage securities market. For the first time, we will practically be able to gage what the private sector can do in the areas which are not already the province of the Government agencies.

I'd like to further comment on two questions which I believe have been asked quite often here.

CAPACITY OF THE PRIVATE MARKET

One is, what is the capacity of the private market, and speaking to Senator Riegle's question, the timeframe? We at Salomon Brothers distribute about $1 billion worth of whole loans a month, and, although it sounds strange, it is much more easy, for a host of technical reasons, to sell $1 billion worth of whole loans than it is to sell $1 billion worth of AAA-rated private mortgage securities.

From our point of view, it is therefore, quite conceivable that with the passage of S. 1821 which would give us the practical ability to do business, that we could immediately—on our own—as one member of the community—look to distribute an equal volume of mortgage securities because we will be able to compete in the marketplace with private mortgage securities.

STAYING POWER OF THE PRIVATE SECTOR

In response to the question of the staying power of the private sector in a high-interest-rate environment, we are, as I believe you gentlemen know, one of the bankers to Fannie Mae, one of the bankers to Freddie Mac, have been involved in the Ginnie Mae program from the very beginning, and are the banker for General Electric Mortgage Securities Co., Residential Funding Corp., and most of the other private issuers of mortgage securities. We've been involved in all of these issuers programs from the outset.

To understand the mortgage securities process, you must realize that it is not more risky to do business in a 17-percent environment than it is in an 11-percent environment. The interest rate environment is outside the whole process. It does not affect the process. RFC from its inception or G.E. from its inception have gone through various interest rate cycles and, simply put, the interest rate cycle does not affect the mortgage securities process, does not make it more risky. Therefore, it is not itself a reason for the private sector to back out.

What interest rate cycles affects is volume, because as the cost of funds to everyone is more expensive, you qualify less buyers, so your volume comes down as a function of rate. Rate does not cause any desire to get out of the market.

The advantage that the agencies might have in a high-interest-rate environment would be to the extent they wanted to deplete their balance to subsidize mortgage rates to create volume—and it would be unlikely that the private sector entity would do that. But there's no business reasons why you would want to get out of the market solely because of high interest rates.

I might conclude by saying that this bill should more properly be termed the private sector existence bill because, as a representative of most of the private sector entities active in the mortgage securities market, I really feel that it is vital to their continued existence.

I think S. 1822, combined with this bill, S. 1821, will collectively make a significant difference, not only in the availability of funds for housing on a conventional basis but also in terms of the cost of such funds. I think it's hard to put the two bills together since S. 1821 is much more concerned with being able to transact business. That, in itself, brings down rate. I think you have seen that already. Traditionally, the nonconforming mortgage rate was 1 percent over the conforming rate. Since we've had competition in the private sector, albeit slight, that rate differential has collapsed to about 40 basis points. I think the collective weight though of S. 1821, a doing business bill, and S. 1822, which is much more directly a lowering mortgage rate, could easily drop the mortgage rate by 50 basis points.

Thank you.

[Complete statement follows:]

Statement of Lewis S. Ranieri,
Managing Director, Salomon Brothers Inc,
before the Senate subcommittee on
Housing and Urban Affairs on S. 1821 -
The Secondary Mortgage Market Enhancement Act of 1983.

Mr. Chairman, members of the Subcommittee on Housing and Urban Affairs. My name is Lewis Ranieri. I am a Managing Director of Salomon Brothers Inc and am Head of our Firm's Mortgage Department. I appreciate your invitation to testify before this distinguished Committee this morning with respect to Senate Bill 1821 - The Secondary Mortgage Market Enhancement Act of 1983.

Salomon Brothers strongly supports legislative action to remove the statutory and regulatory impediments which have prevented privately issued conventional mortgage backed securities ("MBS") from becoming an efficient means of financing residential housing. For many years, Salomon Brothers has been actively involved in developing effective means to utilize the vast resources of the national capital market to satisfy the capital needs of the residential mortage lending industry. In 1977, Salomon Brothers, together with the Bank of America, developed the first privately issued MBS. Subsequently, public offerings of MBSs by private sector issuers have exceeded $3 billion, and Salomon Brothers has been the managing or co-managing underwriter of the majority of these issues. If enacted, we believe Senate Bill 1821 will provide an environment conducive to the expansion of the issuance of MBS by private sector entities to provide the necessary funds to finance the American dream of home ownership for this generation and generations to come. We also believe Senate Bill 1821 will greatly enhance the liquidity of savings and loan associations, the traditional originators of mortgage loans, will more efficiently distribute available residential mortgage credit, and will increase significantly the number and types of institutions which may invest in privately issued MBSs.

I would like to begin my testimony with some general observations which I believe will emphasize the need for an improved environment for private mortgage backed securities. I will then comment upon the specific provisions of Senate Bill 1821.

As you are aware, conventional mortgages have always been the predominant means of mortgage finance for one- to four-family housing. Over the past 13 years, conventional mortgages have accounted for, on average, 80% of annual new mortgage loan originations, and savings and loan associations (S&Ls) have been the major originators of these loans. Until recently, S&Ls have generally been originating these loans to hold as permanent portfolio investments.

The act of pooling mortgages and issuing securities backed by mortgages--mortgage securitizing--has been practiced since 1970 when Ginnie Mae made its debut in the capital markets. To date, a total of $250 billion of residential mortgages have been financed by MBS sold in the capital market, of which more than $170 billion have been GNMAs backed by FHA/VA loans. Although FHLMC's participation certificate ("PC") program has been in existence since 1971 to securitize conventional mortgage loans, it was not until 1976 when FHLMC began to use the Wall Street dealer community to distribute its issues that PC volume began to rise significantly. Nevertheless, during the decade of the 1970s PC issuance amounted to only a little over $21 billion. Not until late 1981 when both FHLMC and FNMA implemented their so-called "mortgage swap" programs have conventional mortgages been securitized on a significant scale.

Since August of 1982, the housing industry has undergone a startling and dramatic recovery. Originations of one- to four-family mortgages in the first six months of 1983 have soared to an estimated $84 billion, more than double the amount for the same period of 1982. We estimate that the total mortgage credit need for 1983 could exceed $170 billion. To efficiently provide this volume of mortgage credit, an effective means of securitization and sale of MBSs is absolutely vital. In the absence of Senate Bill 1821 only about 40% of this amount will be provided through securitization. While this 40% is about twice the amount securitized in 1982, it is far less than the amount obviously needed to bring full efficiency and true economies of scale to the mortgage credit market. Over the next ten years up to $4 trillion dollars will be needed to finance housing. Such amount of financing can only be provided by the capital markets and can only be tapped through a mechanism which allows private issuers to efficiently securitize mortgages and sell the resulting MBSs.

I would like to point out that despite the large issuance of MBSs in recent years, the yield spreads between these mortgage securities and Treasuries have narrowed over this period. For example, the spread between current coupon GNMAs, the benchmark mortgage securities issue, and ten-year Treasuries is currently around 120 basis points, some 25 basis points lower than its average in 1980-82. As the primary and secondary markets are brought closer and as the process of originating and selling mortgages is made more efficient by the provisions of Senate Bill 1821, lower mortgage interest rates at the origination level should result, significantly benefiting potential home buyers.

An important impetus to the future issuance of MBSs will be the gross mismatch between the maturities of S&Ls' assets and liabilities. During the 1980-82 period, their borrow-short-and-lend-long policy resulted in heavy losses for thrift institutions. Although their financial situation has improved greatly, thanks to the dramatic decline in interest rates since August of 1982, the fundamental problem of the maturity mismatch between their assets and liabilities has not changed. Worse yet, the average maturity of their deposits has shortened further, as a result of deregulation which has created new short-term deposits such as NOW, super NOW and MMDAs. To reduce interest rate risk in their future operations, the thrifts, which historically have been responsible for about 50% of total mortgage originations, must adopt a mortgage banking attitude of "originate and sell" instead of "originate and hold." As long as consumers continue to demand long-term fixed-rate mortgages, the thrifts will be under pressure to continue originating long-term loans. Since MBSs are more liquid and marketable than whole loans, however, the ability to securitize efficiently these new originations for subsequent sales, such as is provided by the provisions of Senate Bill 1821, will be of pramount importance to the future health of the thrift industry.

The only way to satisfy the future enormous demand for mortgage credit is to encourage the private sector involvement in the securitization of conventional mortgages as does Senate Bill 1821. Until only recently, conventional loans have been predominantly funded by the thrifts with savings deposits. Federally sponsored agencies have been peripheral to housing finance, playing a countercyclical role whenever "disintermediation" curtailed the ability of the thrifts to self-fund mortgage loans. These agencies have been able to play this role as they are specifically exempted from the strict requirements imposed on private issuers of MBSs. In this environment, there was no compelling need for a significant involvement of the private sector in providing housing finance and, consequently, no specific legislation existed. As the thrifts are now no longer in a position to self-fund housing, there is an urgent need for legislation which will further enhance the role of the private sector and the capital markets in providing housing finance.

In the future, mortgage backed securities will provide the liquidity necessary for healthy mortgage asset management and will enable market risk of long-term fixed rate mortgage loans to be shared by a broader investor base. A new era of mortgage backed securities will be introduced when we target specific investors with specific types of issues of mortgage backed securities. We are now developing mortgage securities that will provide thrifts with the short maturities they need to match against their shortterm liabilities; life insurance companies with the medium-term maturities they desire; and pension funds with the long and stable maturities they require. Senate Bill 1821 will address each of these investor categories, as well as others, and will open up important new sources of mortgage credit.

I would like now to comment upon the specific provisions of Senate Bill 1821.

The expansion of exemption from registration under the Securities Act of 1933

Congress has previously seen fit to exempt large transactions involving first mortgages from registration under the Securities Act of 1933. First mortgages on commercial properties have also been included in this exemption. The language of the current exemption discriminates, unfairly it seems, against certain classes of mortgage originators as well as against certain types of mortgages which are not covered. The legislation, as introduced, eliminates or cures this disparity in treatment. Because the legislation would give mortgage bankers, who have become an increasingly significant source of finance for the housing market, equal treatment under Section 4(5) with other classes of mortgage originators, we strongly support this section of the legislation.

We also support the inclusion of so-called transactional second mortgages and mortgages on manufactured housing and cooperative apartments. Such loans, particularly loans secured by manufactured housing, have become increasingly important factors in the housing industry and should certainly be given comparable treatment to first mortgages on real estate, particularly when such real estate may incude commercial properties.

We also support the preservation of the Section 4(5) exemption in respect of securities which, because of large principal paydowns, may suddenly fail to be eligible for such treatment under Section 4(5) as currently written. It is difficult to make a market in a security on an exempt basis when the possibility exists that it will soon not be exempt and will lose its original ready marketability.

We also support the extension of time within which a transaction qualifying under Section 4(5) may be closed. This extension of time is necessary in order to correspond with the origination process whereby mortgages are originated for inclusion in securities packages for which purchase commitments have previously been obtained. Since, however, this process frequently takes longer than 120 days, we believe a 180-day requirement would be more realistic.

The legislation would also extend the coverage of Section 4(5) to debt obligations which are payable from the cash flow of mortgages which themselves qualify for the 4(5) exemption. This type of instrument has been used extensively by homebuilders and savings and loans associations and is beginning to find increasing acceptance in so-called "fast pay-slow pay" structures wherein the cash flow from a pool of mortgages is carved up and tailored to suit the requirements of particular types of investors. The passage of the proposed TIMS tax legislation, which facilitates this feature, will further enhance the future use of cash-flow bonds.

Since "mortgage related payment bonds" depend upon the cash flow from the underlying mortgages for their payment, we find it inconsistent that the mortgages themselves would qualify for Section 4(5) treatment under the legislation, without a rating while a rating would be required for the bonds which they support. Since the original Section 4(5) was enacted primarily to facilitate the purchase and sale of whole loan packages, which are never rated, it would be proper to conform the treatment of bonds and mortgages by elminating the rating requirement for bonds. The philosophy behind Section 4(5) is that sophisticated parties will be on both sides of a $250,000 cash transaction, and we question whether a rating requirement is consistent with this philosophy.

A substantial number of issues of cash-flow bonds have been backed by MBSs guaranteed by GNMA, FHLMC and FNMA. We have always felt that such instruments should be treated as participations in mortgages for certain statutory purposes and assume that they would be included as such in the first part of Section 101. If that is true, "mortgage related payment bonds" backed by GNMAs, FNMAs or FHCMC PCs would qualify for Section 4(5) treatment. The current interpretation of Section 3C(5)(C) of the Investment Company Act of 1940 (which exempts companies primarily engaged in purchasing mortgages from registration as investment companies) would, however, contradict this assumption since such guaranteed participations are considered to be securities and not mortgages for purposes of that Section. We feel that language clarifying that mortgage passthrough securities guaranteed by GNMA, FNMA or FHLMC are mortgages for purposes of Section 4(5) and Section 3C(5)(C) would be particularly desirable since these securities are increasingly utilized by the private sector as collateral for cash-flow bonds. Since the legislation is designed to equalize the treatment of MBSs issued by the private sector and MBSs issued by federally-sponsored agencies or instrumentalities, such a clarification would be consistent with that underlying purpose for it would treat collateral pools composed of private and federal MBSs comparably under both the Securities Act of 1933 and the Investment Company Act of 1940.

Margin loans by brokers on Private MBSs; borrowing by brokers on MBSs

At the present time, private MBSs are disadvantaged in comparison to Government securities such as FNMAs and GNMAs with respect to both (1) the ability of broker-dealers to extend credit to buyers of MBSs, especially in connection with their initial issuance and distribution, and (2) the ability of broker-dealers to borrow on MBSs.

Section 11(d) of the Securities Exchange Act of 1934 ("1934 Act") prohibits a broker-dealer from extending margin credit to buyers of MBSs on initial issuance if the broker participated in the underwriting. This prohibition has been construed to prohibit "when issued" trading of MBSs prior to settlement. Although comparable restrictions apply to corporate debt securities, these restrictions are not a meaningful constraint since corporate bonds or debentures are customarily issued for one-week settlement. As I have previously pointed out, MBSs are frequently sold for delivery over a period consisting of several months. The inability of brokers to extend credit and to participate in a "when issued" market discourages prospective purchasers and impedes the sale of new issues of MBSs.

In the secondary market, Regulation T of the Federal Reserve Board permits a broker to extend credit on outstanding MBSs only if they are listed on a securities exchange or qualify as "OTC" margin bonds, which requires an issue size of at least $25 million and registration with the SEC under the Securities Act of 1933. Most private MBSs do not so qualify. The inability of broker-dealers to extend margin loans on most MBSs has the undesirable effects of impeding sales in the secondary market and reducing the desirability of MBSs as investments.

Section 102 of the legislation would remove these disadvantages by permitting brokers to extend credit on MBS, including credit on initial issuance, and to finance their own inventories to the same extent as Government securities. By permitting their use in repurchase agreements, additional liquidity and attractiveness would be provided for MBSs.

I would like to point out that since the legislation does not classify MBSs as "exempted securities" under the Securities and Exchange Act of 1934, these additional powers, which we find so essential, would be limited to broker-dealers registered under such Act and subject to supervision and regulation by the Securities and Exchange Commission.

Net capital requirements on MBSs

The ability of dealers to provide an effective secondary market for the increasing volume of outstanding private MBSs is restrained by the treatment of those securities under the net capital requirements applicable to securities dealers, which is similar to the treatment of corporate debt securities. We believe that different treatment for private MBSs is appropriate for two reasons. First, the nature and size of the secondary market for MBSs requires that dealers carry in their inventories significantly larger volumes of these securities than dealers in the corporate bond market must carry in order to provide an effective secondary market. Second, MBSs issued by GNMA, FNMA and FHLMC are given the same treatment under the net capital rules as are United States Treasury securities. This more favorable treatment permits dealers to carry sufficient amounts of these MBSs to provide a highly efficient secondary market. The much smaller amount of private MBSs which dealers may carry with a given commitment of capital has impeded the development of the secondary market for these securities. In order to carry a given dollar amount of investment grade private MBSs, a dealer must commit 1 1/2 times the capital required to carry the same amount of agency MBSs or ten-year Treasury securities. This significantly higher capital commitment limits the volume of trading a firm can do and results in higher dealer markups on trades. Imposing the same net capital requirement on private MBSs as is imposed on agency MBSs would permit dealers to increase the volume of trading without a corresponding increase in capital and reduce their markups on trades, thereby helping to narrow the difference in yields between the two types of securities and lower the cost of mortgage money.

Investment by financial intermediaries

The bill would permit federal savings institutions and credit unions to invest in private MBSs. This change should help increase the availability of mortgage money and improve liquidity for investors in the mortgage market.

Preemption of state legal investment and blue sky laws

Section 106 of the bill would preempt state legal investment and blue sky laws with respect to private MBSs, subject to the option of a state to override the preemption within two years.

We have found in our role as the leading underwriter and dealer in private MBSs that such securities are severely disadvantaged under the state legal investment laws when compared to agency MBSs and corporate bonds. Most state legal investments statutes, which govern investments by state-chartered banks and thrifts, pension funds and insurance companies, were drafted many years ago when MBSs did not exist. With their status as federal agency securities, agency MBSs are legal investments for nearly every category of investor in every state. By way of contrast, private MBSs are not legal investments for insurance companies in most states, even with the highest possible ratings from the rating agencies. An example of the unfavorable treatment accorded MBSs under these laws is a comparison of the legality of a "BBB" or "Baa" rated corporate debenture issued by a corporation which has had a relatively modest level of earnings over the past five years (averaging 1 1/2 times its interest expense). Such debenture is legal for nearly all categories of investors in all states. Private MBSs with the highest rating obtainable from both Standard & Poor's and Moody's would, however, only be legal for savings banks and public retirement systems in some states, for private pension funds in most states and for insurance companies in only a very few states. We believe that the credit quality of mortgage backed securities which have investment grade ratings reflects their diversification of risk among many mortgages, and is significantly better than the credit quality of comparably rated corporate securities which are currently legal for these types of investors.

We note, however, that the current draft legislation does not impose a rating requirement as a condition to the availability of the preemption. We feel that an investment grade rating is essential in connection with the preemption, since the preemption would then not permit any reduction in the quality of investments which regulated investors could purchase. Since the credit of GNMA, FNMA and FHLMC are different from private credits, we do not feel that a rating requirement for their MBSs or for bonds backed by their MBSs is needed, however. Also, we note that registration of the MBS under the 1933 Act is required as a condition to availability of the preemption. We believe this is unnecessary for three reasons. First, it is inconsistent with the philosophy of expanding Section 4(5) of the 1933 Act. Second, many issuers (banks, thrifts and the Federal agencies) are not now required to register their securities. Third, existing state legal investment laws do not impose a 1933 Act registration requirement.

The bill would also preempt state "blue sky" laws which require the registration with state security commissioners of many publicly offered securities. Agency issued mortgage back securities are exempt from these requirements in nearly every state. Securities issued by corporations whose stock is listed on a major stock exchange, or in some cases, traded in the over-the-counter market, are exempt from the blue sky requirements in approximately 45 states. Investment-grade private MBSs are safer investments than the securities of most listed companies. With the addition of a rating requirement as a condition to availability of the exemption from blue sky laws, we strongly support the preemption for private MBSs. We believe that the preemption for these securities is consistent with the investor protection philosophy of state blue sky laws and, at the same time, would significantly reduce the cost of issuance of private MBSs, thereby helping reduce the cost of mortgage money.

TIMs

Senator Tower also asked that I comment briefly on S. 1822, popularly known as the "TIMs bill", which is now before the Finance Committee. We strongly support the philosophy of this legislation and urge its enactment. We do have a few specific suggestions to make on this legislation, however, and hope to have the opportunity to raise them at the appropriate time in the Finance Committee. Nevertheless, one point I do wish to make before this Committee is that securities issued under the authority granted by the "TIMs bill" must be qualifying assets for thrift institutions under §§ 593(d) and 7701(a)(19) of the Internal Revenue Code if they are to be at all competitive with MBSs issued by GNMA, FNMA and FHLMC, which under current law enjoy such status. Without such qualifying asset status, private TIMs securities would not be able to be bought by thrifts, thus eliminating a very significant potential market for this type of security. Without access to the thrift market, we do not believe issuers of MBSs will avail themselves of the opportunities contained in the TIMs legislation, but will continue to use the current inefficient "grantor trust" structure, and the strenuous efforts of so many in behalf of the TIMs bill will have been fruitless.

Senator TOWER. Thank you, Mr. Ranieri.
Mr. Fink.

STATEMENT OF LAURENCE D. FINK, MANAGING DIRECTOR, THE FIRST BOSTON CORP., NEW YORK, N.Y.

Mr. FINK. Thank you, Mr. Chairman.
[Complete statement follows:]

September 22, 1983

STATEMENT
ON
THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983
BEFORE THE
SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
BY
LAURENCE D. FINK
THE FIRST BOSTON CORPORATION

My name is Laurence Fink and I am a Managing Director of The First Boston Corporation and in charge of our Mortgage Products Group. With me today is Michael Zeiss, First Boston's Assistant General Counsel. First Boston is a leading international investment bank and our Mortgage Products Group is believed to be among the finest on Wall Street. The Mortgage Products Group is specifically charged with serving the investment banking needs of the thrift industry, and more broadly, the mortgage financing needs of the nation. This includes such activities as trading and sales, underwriting, stock conversions, financial advisory services and dealing in all mortgage related securities, of both the private and public sectors. It is from this perspective that I address you today, and I thank you for the opportunity to do so.

The express purpose of Title I of S. 1821 is to amend certain laws so as to (1) allow private mortgage-backed securities to be sold more freely in the capital markets and (2) broaden investor acceptance of these securities. Although both of these objectives are gradually being met through the natural evolution of the mortgage markets, enactment of S. 1821 would certainly accelerate this process. We believe that such acceleration is necessary in order to assure the continuous and competitive delivery of mortgage credit in America following the recent financial institution deregulation, and we support your efforts.

The amount of mortgage debt currently outstanding is in excess of $1.7 trillion. This amount exceeds the federal deficit by more than $400 billion. However, it was not until 1970 that mortgage debt was securitized and distributed in the secondary market. By most measures the growth of the mortgage backed securities market from 1970 to the present has been significant. With GNMA, FHLMC and FNMA accounting for most of this activity, we estimate that the compounded average growth rate of MBS's has exceeded 60% to date. In the first six months of 1983 alone, newly originated mortgages totalled about $84 billion; at the same time nearly $35 billion in MBSs were issued. Annualizing these rates, 1983 should see close to $70 billion of new MBSs on a base of approximately $168 billion of new mortgage debt.

Most of this growth, however, has been accomplished with very little participation by the private sector. In fact, through June of 1983 private sector MBSs totalled less than $10 billion, while those of GNMA, FHLMC and FNMA combined totalled almost $230 billion. Due to certain securities and tax laws that predate the dawn of MBSs, the private sector percentage of the total MBS market has been kept rather low. However, interest rate deregulation and volatile capital markets have mandated that mortgage originators rely more heavily on the secondary market, yet the tools of their trade are outmoded. S. 1821 is a positive step toward retooling the industry, however, taken by itself, S. 1821 it is not a panacea.

Specifically, S. 1821 ignores what is perhaps the biggest impediment faced by pass-through MBS issuers - i.e., qualification as a Grantor Trust. Such qualification is a prerequisite for two important reasons. First, it allows pass-through MBSs to qualify as a sale of assets for financial reporting purposes. Second, it avoids taxation at the pool level and passes the liability down to security holders. Without the above treatment, pass-through issuers have little incentive to access the secondary market. However, in order to qualify as a Grantor Trust mortgage pools must forego active management of cash flows. It is this restriction that severely limits the creation of the new type of MBSs that the private sector needs to flourish in the current economic and regulatory environment.

For this reason we believe S. 1822, the TIMs legislative proposals - ought to be considered simultaneously with S. 1821. Because we recognize that S. 1822 is being considered by another committee, we limit our comments on that bill by simply saying that: (1) First Boston believes strongly in the need for the TIMs legislation (2) in order for TIMs to be a success it must provide full powers for both FNMA and FHLMC (3) only after the private sector has had a chance to utilize the powers given in S. 1821 and S. 1822, should the present role of FHLMC and FNMA be considered for change. The mortgage credit distribution system in America is presently too fragile, and the Agencies represent the mainframe of this system. (4) GNMA, FNMA and FHLMC MBS programs have set standards for the industry during the past 13 years, and provided the necessary fungibility and reliability upon which the young market could develop. The private sector MBS market is immature and will require leadership to fully develop its potential. Such leadership must come from the Agencies until the private sector can stand alone. During this period the Agencies must continue with full powers, including inflation adjusted loan limits, so they can perform this necessary function. At this point First Boston is not in a position to comment on specific Agency loan limits, however, we believe that, in any case, an inflation adjustment of those limits should continue to be authorized.

I'd like now to direct my remarks to the specific sections of the Secondary Mortgage Market Enhancement Act of 1983.

Section 101 would broaden the exemption from registration under the Securities Act of '33 [Sect. 4(5)] which presently limits thrifts and commercial banks to selling only first mortgage pass-throughs. Due to these present restrictions, it is estimated that less than $1.5 billion of private mortgage pass-throughs were sold pursuant to this exemption in the past 12 months.

The two major alternatives available to depository institution MBS issuers have been, and continue to be, whole loan sales and Agency MBS programs. While all six provisions of the Section are positive for MBS issuers, none alone can be expected to significantly alter the existing preference for the alternatives.

However, when added together we expect private sector MBS issuance to increase measurably. Mortgage bankers should become more frequent issuers once freed of registration requirements, and the 120 day delivery window creates added flexibility for sellers without much additional risks.

Section 102 is a positive enhancement which would facilitate the purchase of newly issued MBSs. Presently, only government and agency securities are allowed to be purchased on margin. Although most newly issued MBSs are not delivered to investors until sixty days (under existing regulations) after their purchase, certain investor types, particularly S&Ls, still have a preference for financing the securities when delivered. For instance, an S&L may have made the investment decision to purchase a MBS but, by the time the delivery date arrived, it found itself in a less liquid position. With Section 102, such a purchaser could then margin its purchase through the use of a reverse repurchase agreement with a broker-dealer. This type of purchaser flexibility will broaden and deepen the investor market for MBSs.

In considering Section 102 we would like to point out that Section 7(c) of the Securities Exchange Act of 1934 would also be addressed so as to provide for consistent treatment, and fully accomplish the objectives of this Section.

Section 103 is a clear improvement to existing regulations. Under present NYSE net capital rules broker-dealers are subject to as much as 9% regulatory "haircut" on private mortgage securities. GNMAs, FNMAs and FHLMCs MBSs, however, only receive a "haircut" of 3%. Eliminating this disadvantage would be a minor inducement to well capitalized broker-dealers to provide better markets in private mortgage securities. The positive impact on less well capitalized regional dealers, however, would be more significant.

Section 104 should broaden the investor market for both private and public mortgage securities to a moderate degree. The concept of looking to the mortgage pool rather than the issuer for making credit determinations is something that participants in the mortgage market have grown to accept. Amending the Home Owner's Loan Act of 1933 and the Federal Credit Union Act as proposed will underscore the diversification of risk inherent in mortgage pools. It should encourage additional investments by both national banks and credit unions, both of whom have had limited participation in the mortgage market heretofore.

Section 105 raises issues which go significantly beyond the underlying purposes of S. 1821. Specifically, this section would allow national banks to underwrite and deal in investment grade mortgage related securities. This power would constitute a very significant relaxation of a key provision of the Glass Steagall Act. In light of the very substantial attention that is being given to broad issues of allocation of powers among financial institutions as focused by the Depository Institutions Moratorium bill and the Financial Institutions Deregulation bill, we believe that it is inappropriate to address this issue in the context of S. 1821. In addition, we believe it is unnecessary to address the issue inasmuch as we believe that the existing dealer market can provide adequate depth and liquidity to the secondary mortgage market in the context of the enhancements otherwise contemplated by S. 1821.

Section 106 has more far-reaching potential than the other sections. Not only will it obviate the need for expensive legal investment and blue sky surveys, but it will increase substantially the institutional market for private mortgage securities. This section grants to private mortgage securities an investment status equivalent to U.S. Government securities, which is not enjoyed by corporate debt obligations. Such special status is sure to redirect certain investment funds away from corporate obligations and perhaps even U.S. Government securities toward mortgage securities.

One anomaly which appears in this Section, however, is that the statutory language does not clearly provide for equal treatment of private MBSs and those issued by FHLMC and FNMA as is stated in the Section-by-Section analysis. We believe it is the intention of this bill to accomplish such parity.

Section 107 would require the SEC to continue Rule 415 for the mortgage securities market. Rule 415 has made great strides in streamlining registration procedures for mortgage securities, and we believe the mortgage securities market would be set back without continued availability of the Rule.

In summary, First Boston believes that this committee has taken a large and necessary step toward facilitation of the secondary mortgage market. Without this legislation, mortgage originators would be forced to continue operating their business with many unnecessary handicaps; investors, on the other hand, would continue adding private MBS to their portfolios only in very modest amounts. However, passage of this legislation, and its companion S. 1822, will help create a well-balanced mortgage credit distribution system and insure the continuous and competitive provision of such credit to the future homeowners of America.

Senator Tower. Thank you, Mr. Fink.
Mr. Pratt.

STATEMENT OF RICHARD T. PRATT, PRESIDENT, MERRILL LYNCH MORTGAGE CAPITAL, INC., NEW YORK, N.Y.

Mr. Pratt. Thank you, Mr. Chairman. It's a great pleasure to be back here in a somewhat different capacity than last time I may have appeared before you gentlemen, and I would like to just express my appreciation for being here and my personal knowledge of the interest of both Senator Tower and Senator Riegle have long taken in the financial markets, housing, and the financial institutions area and to express my appreciation for the help and counsel which they gave me when I was an official in Washington.

I further commend the committee for bringing forth this legislation. I think it represents a leadership that is resident in this chamber and the fact that my views of this type have been around for some time and it is this committee and this group that brings them forth I think requires commendation also.

In looking at the circumstances which we are faced with at this time and the evolution of the mortgage and securities market, I think it's most fascinating. I'll make very brief comments and would ask that my statement be included for the record in its written form.

The history of the mortgage markets and capital markets was really quite separate until a very recent period of time. The mortgage markets operated essentially under the dominance of highly regulated financial institutions which were restricted in the rate they could pay for funds and which were highly channeled in the area in which they could invest.

So we had a market which really existed separately from the Nation's capital markets.

As technology and deregulation and social change overcame these institutions and they became faced with the era of deregulation and the need to compete in open markets, this suddenly threw the mortgage market I think into the mainstream of American capital markets and we can't underestimate the importance of this in the financial evolution of this country and its financial markets. The size of the mortgage market has been cited by my colleagues here on the panel. It's the largest capital market in the world virtually and it is one which was sheltered from the normal processes of the capital markets. It's one which is now coming into the capital markets that ought to come in as efficient a process as is possible.

There are many ways that housing can be assisted in this country, including direct subsidies which represent the payment of one person's housing by another person. There are other methods which are based on increasing the efficiency of the markets in which housing is provided, and I believe that this legislation is a win-win proposition. That is, it increases efficiency; it makes housing and housing finance more available at a lower cost and it does not represent the transfer of payments from one set of taxpayers in this country to another.

It's the kind of legislation which I think really advances our system and improves the standard of living of the American people and helps keep our capital markets the best in the world.

MORTGAGE MARKET FEDERALIZED

In terms of the bringing together of these markets, the mortgage market to a very large extent is federalized today through one form or another, either through the portfolio lending of federally insured institutions which with their deregulation have an immense amount of funds, have the right to offer Federal insurance and provide an aspect of federalization in the mortgages which they might deal in.

Second, clearly in the areas that conforming product exists, the Federal guarantee dominates the market. Freddie Mac, Fannie Mae and Ginnie Mae, with their Government backing, make the development of private market mechanisms in directly competing products extremely difficult.

Outside of the areas in which they qualify, of course, we're seeing the rapid development of a very viable secondary market. This legislation would immensely enhance those areas as well as make even conforming product more competitive with the Government-sponsored areas.

In short, I would like to say that we support both S. 1821 and S. 1822. We think it's substantial legislation. It's legislation dealing with the Nation's largest capital market. It improves the efficiency. We recommend the passage of this legislation.

We have some technical comments which are included in our statement. Thank you very much. Mr. Chairman.

[Complete statement follows:]

September 22, 1983

STATEMENT OF RICHARD T. PRATT, PRESIDENT,
MERRILL LYNCH MORTGAGE CAPITAL, INC.,
BEFORE THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

My name is Richard Pratt. As President of Merrill Lynch Mortgage Capital, Inc., I am pleased to appear before this subcommittee to testify on S. 1821, the Secondary Mortgage Market Enhancement Act, and on the companion tax legislation, S. 1822, the Trusts for Investment in Mortgages Act.

I would like to direct my comments to three aspects of the proposed legislation. First, I will address the general purpose of the Trust for Investment in Mortgages ("TIMs") concept and its relationship to an active, private, secondary mortgage market. Second, I will briefly comment on specific technical aspects of S. 1821 relating to the bill's proposed amendments to the securities, banking, and other laws designed to remove existing impediments to the development of an active, private, secondary mortgage market. Finally, I will address the companion tax legislation for TIMs, S. 1822, since that companion piece of legislation is absolutely essential to any successful legislation in this area.

Merrill Lynch Mortgage Capital, Inc. is a newly founded subsidiary of Merrill Lynch Capital Markets, the global investment banking arm of Merrill Lynch & Co. As the company name implies, Merrill Lynch Mortgage Capital, Inc. was organized to further Merrill Lynch's activities in bringing to fruition what we believe is the growing union of the nation's capital markets and its mortgage credit markets.

As a leader in investment banking with a large retail and institutional clientele, Merrill Lynch has been at the forefront of many of the recent changes in mortgage credit markets. Through Merrill Lynch Realty, Inc., Merrill Lynch is now actively engaged in the marketing and financing of residential real estate. A variety of innovative retail financing programs brings the retail consumer ready access to credit on the strength of homeowners' equity. We see great potential for both Merrill Lynch and the marketplace to finance home mortgages by tapping the capital markets through the issuance, underwriting, or sponsorship of mortgage-backed securities or, in other words, TIMs.

As this Committee is well aware, for many years the home mortgage credit market occupied a distinct niche in the nation's credit markets partially divorced from the mainstream credit and capital markets. As a result of a changing economic environment, the sources of funds for the traditional suppliers of mortgage credit are now more costly and more volatile. In the face of this increased economic and financial risk, traditional lenders are relying more heavily on the sale of home mortgages in the secondary market, and many portfolio lenders have come to look more like mortgage bankers who originate and service mortgages.

Indeed, the Mortgage Bankers Association of America estimates that nearly sixty percent (60%) of the mortgage loans originated in 1982 were sold into the secondary market. This compares to an average of only 30% during the decade of the 1970's. This is, of course, a result of the economic difficulty experienced by traditional portfolio lenders such as thrifts. Industry sources predict that by 1990, or perhaps earlier, seventy-five percent of all mortgages originated will be sold in the secondary market. In sum, the mortgage credit market is becoming increasingly indistinguishable from the nation's capital market.

The secondary market, of course, has traditionally been and is now dominated by three Government-backed entities -- the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC"). Their dominance of the secondary mortgage market is, in some measure, an indiction of their success in carrying out their designated public functions in the formation of a secondary market and as major suppliers of mortgage credit. Although the absence of private participants in the secondary mortgage market may not necessarily be a result of these government agency successes, there is no doubt that provisions of existing tax, securities, and other laws have hampered the development of an active, private secondary mortgage market.

By proposing to remove those impediments, the bills introduced by Senators Garn and Tower are an essential first step in the development of a private secondary mortgage market. As such, we applaud the concept and intent of S. 1821 and S. 1822.

The TIMs proposal properly recognizes that, because the nation's mortgage credit markets were for so many years separate from its capital markets, securities, banking and other laws -- drafted and enacted without the notion of mortgage-backed securities in mind -- have inadvertently created barriers to the efficient union of those markets. The proposed Tower-Garm legislation is a salutary and constructive measure, necessary to eliminate those inadvertent barriers. The proposed legislation, also quite rightly, does not attempt to unduly fetter the TIMs with its own set of regulatory paraphernalia, but happily, after setting forth basic guidelines, leaves that work to the marketplace. This approach -- which places the TIMs mortgage-backed security on basically the same footing and subject to the same regulatory regime as any other publicly- or privately-placed security -- will permit necessary and adequate disclosure to the public while allowing TIMs sponsors and issuers and the marketplace to develop the kinds of mortgage-backed securities which can appeal to a wide range of investors and thus make the mortgage market a truly efficient and economic credit market.

We believe, therefore, that the goals of this bill are laudable and that our community of interest lies in assuring that the proposed legislation accomplishes these goals by (1) reducing the unintended impediments denying mortgage-backed securities full and equal access to the nation's capital markets;

(2) placing mortgage-backed securities on an equal footing with other, comparable investment-grade securities; and (3) by so doing, allowing these instruments to be used flexibly and innovatively to meet the requirements of a wide variety of investors. We believe that the result of such a framework will be the development by private industry of an efficient mortgage capital market. The ultimate beneficiary of these reforms, of course, will be the nation's home buyers who will enjoy the benefits of a more competitive and flexible marketplace.

Allow me now to make some specific comments about certain technical aspects first of the regulatory bill and then on the companion tax legislation.

Amendments to Existing Securities, Banking, and Other Laws

The proposed expansion of the so-called "Section 4(5)" transactional exemption for large sales of mortgage-related securities contained in Section 101 of the bill is, in our view, an appropriate and desirable mechanism for improving the private secondary mortgage market. There is, no doubt, a large source of mortgage credit in private and public pension funds that can be tapped through Section 4(5) placement of mortgage-backed securities. We believe, however, that a lower threshold amount for Section 4(5) transactions of $100,000, as opposed to the $250,000 in the bill, would be more appropriate. While many of the transactions that could be accomplished through such sales will certainly be well in excess of $250,000, it should not be overlooked that small institutional and substantial individual investors are also a significant part of the untapped mortgage credit market; a lower threshold amount, such as $100,000, would permit these sales to reach that market, yet would be a sufficiently large amount to serve the purpose of such a limitation -- to shield the less sophisticated investor.

Sections 102, 103, and 104 of the bill, we believe, will appropriately place mortgage-backed securities on the same footing as other securities of "investment grade" quality, will encourage their purchase by the nation's financial institutions, and are thus consistent with the overall statutory scheme.

In addition to these amendments in current banking laws, the legislation should also include a provision that TIMs will be (1) included within the Internal Revenue Code percentage of assets test for defining a savings and loan association or within "gross income" under IRC Section 593 for determining an association's bad debt reserve deduction, or (2) included as a debt instrument for determining a bank's bad debt reserve under IRC Section 585. The mortgage-related securities of GNMA, FNMA, and FHLMC are included in these preferential tax provisions. For TIMs to be competitive with investments for purchase by savings and loan associations and banks, the Internal Revenue Code should enable them to realize the same tax benefits currently available for investments in GNMA, FNMA, and FHLMC mortgage-related securities.

Section 105 of the bill would grant national banks the authority to underwrite and deal in mortgage-backed securities. Under present law, banks are prohibited by the Glass-Steagall Act from underwriting or dealing in all but limited categories of government securities. Although the Section 105 deregulation measure deserves serious consideration, it should not be included in this TIMs legislation but should, instead, be considered in the context of a much broader financial services deregulation program.

As a companion feature to Section 107 of the bill which mandates a Securities and Exchange Commission ("SEC") rule or regulation to accommodate shelf registration of mortgage-backed securities, we believe it may be appropriate to permit, but not require, TIMs to become registerd mutual funds under the Investment Company Act of 1940. We expect that a TIM would operate in many ways like a mutual fund and that an explicit provision authorizing registration pursuant to the '40 Act will promote flexibility and innovation in the development of TIMs while subjecting them to a legal regime already in place for comparable investment vehicles.

We also would note that the need for relief from certain ERISA prohibited transaction coverage of private pension fund investments has been recognized by the TIMs legislation sponsors, but neither S. 1821 and S 1822 nor any other legislation provided the appropriate ERISA revisions. A comprehensive TIMs program requires the enactment of ERISA reforms to enable the sale of TIMs securities to private pension funds. The new legislation should, therefore, amend ERISA to provide that mortgage-related securities, and not the underlying mortgages, are the assets of the pension plans purchasing these securities. Such "plan assets" relief will end the inappropriate application of certain ERISA provisions concerning fiduciaries to sponsors and servicers of mortgage-related securities. Also, an ERISA exemption from prohibited transaction provisions would be appropriate for "arms-length" TIMs transactions conducted in accordance with customary practices in the residential mortgage and mortgage-related securities industry.

Taxation

Although we realize that the companion bill to S. 1822, the proposed revisions to the tax code for TIMs, will be considered by the Senate Finance Committee, we nevertheless thought it important to address ourselves generally to that bill as well since revisions to the tax code play an integral and essential part of any effort to encourage development of an active, private secondary mortgage market.

In his remarks introducing S. 1822, the proposed special tax rules for TIMs, Senator Tower rightly noted that present "grantor trust" tax doctrine has been too inflexible in its application to pooled mortgage investments. Current law unnecessarily constrains the ability of mortgage-backed securities to compete in the capital markets by imposing an insupportable burden of double taxation if the pool trustee is authorized to reinvest mortgage prepayments or otherwise actively to manage cash flows of the pool. In order to avoid such taxation, most mortgage-backe securities have been designed as passive grantor trusts, satisfying restrictive "pass-through" requirments. The disadvantages of such "pass-through" vehicles have been noted at length: the investor has no protection against prepayment of the mortgages in the pool; the term of repayment becomes undependable; and the investor is uncertain as to what he is buying. For that uncertainty or lack of "call" protection, the investor demands a premium ultimately increasing the mortgage costs for homeowners. Also, under current grantor trust law, an issuer of certificats backed by a mortgage pool cannot issue different classes of securities tailored to the requirements of different classes of investors.

The TIMs tax legislation, we believe, reacts sensibly to these concerns; and, in concept, we applaud it. The bill is designed to remove these unnecessary impediments, promote flexibility, and allow the marketplace to operate. As drafted, however, the legislation leaves some questions unanswered. Without addressing all these issues in detail, it is appropriate to address a few of the legislation's major themes.

Foremost among the bill's major themes is the adoption of a flexible and workable pass-through regime. The bill, properly we think, avoids the REIT formula of taxable entity and dividends paid deduction and provides, instead, that a TIM will be exempt from income tax while its shareholders will, in the aggregate, annually account for all of the income, gains, and deductions generated by the TIMs mortgage investments. This underlying concept that focuses the incidence of taxation exclusively at the investor level is exemplary. On the other hand, we believe that the mechanics of implementing that concept, by resorting to the complex partnership tax rules implicating a series of mandatory and elective adjustments, are unnecessary and could be avoided through a more fully articulated statutory scheme.

Under present law, principal payments allocable to the recovery of market discounts on corporate indebtedness are taxed as capital gain. On the other hand, for TIMs securities holders, the recoupment of market discounts through principal repayments will be taxable as ordinary income. So that TIM securities can properly compete on more comparable terms with corporate bonds, the same capital gains treatment for the recovery of market discounts should also be accorded to holders of TIMs securities.

While the bill focuses mainly on investors' transferring cash to a TIMs in exchange for shares, it also contemplates a transfer of home mortgages to a TIMs in exchange for shares and provides that the TIMs shall "mark the mortgage to market" at the time of the exchange. "Marking to market" seems appropriate in facilitating subsequent tax accounting as payments on the mortgages are received, but we believe the legislation is wholly wrong in going on to provide that the shareholder must treat the exchange as a taxable event and recognize the resulting gain or loss over the remaining term of the mortgage transferred. A simpler, less intrusive approach would provide a "carry over basis" for the TIMs shares, in keeping with present tax treatment for property contributions to a partnership. In other words, the taxpayer's basis for the contributed mortgages would become the basis for the TIMs shares received in exchange.

As we have previously noted, the inflexibility of current grantor trust doctrine blocks the reinvestment of mortgage prepayments needed for protection and the issuance of multiple classes of shares of mortgage-backed securities. Recent IRS positions, however, have shown evolving flexibility in other areas of grantor trust law, particularly with regard to bond-type payment schedules of principal and interest and certain guarantees for the timely payment of principal and interest. While the rationale for these recent IRS positions unfortunately does not offer the possibility that the grantor trust doctrine would ever allow reinvestment of prepayments and call protection, these IRS positions should not be disturbed by this legislation. Merrill Lynch and other investment bankers and issuers do sell certain mortgage-backed securities which will not be eligible for TIMs tax treatment. The TIMs legislative record and S. 1822 both should evidence an intent of Congress to preserve the recent IRS grantor trust rulings and the evolving flexibility of the IRS. For example, an IRS retreat from current grantor trust flexibility would adversely affect certain financings for multi-family housing, commercial property mortgages, and construction loans.

S. 1822 provides (in proposed subsection 860(b)(4)(C) of the Internal Revenue Code) that a TIM may not receive income from services performed by the TIM. Our understanding is that the proposed legislation contemplates that a TIM sponsor (such as an issuer of securities and packager of mortgages for a TIM trust) may provide mortgage and investor servicing for a TIM and collect a servicing fee. The legislation should make clear that a TIM sponsor, as opposed to the TIM itself, may, without any penalty to the sponsor of the TIM, provide servicing for a fee.

In sum, the tax law has operated as a major impediment to investment in home mortgages and, thus, is poor public policy. We believe the tax law regarding mortgage credit should operate in a neutral way; it ought not discourage investment in home mortgages. By the same token, it ought not artificially encourage these investments by allowing an investor who is earning a profit to report a tax loss. If the tax law is rendered neutral, pooled investments in home mortgages can stand on their own and compete effectively in the capital markets.

Mr. Chairman, this, I believe, defines the community of our interest. There are many legislative proposals regarding the deregulation of the nation's financial industries now pending in Congress. Irrespective of the outcome of these legislative proposals, the TIMs legislation, S. 1821 and S. 1822, clearly can stand alone and should be enacted on its own merits. Like this Committee, we are interested in promoting a flexible and efficient marketplace for home mortgage investments. With the introduction of these two companion bills, that effort is well underway.

I thank you and the members of the Committee for the time allotted me today. I would be pleased to answer any questions from the Committee.

Senator **Tower**. Thank you very much, Mr. Pratt.
Mr. Scott.

STATEMENT OF PHILIP C. SCOTT, PARTNER, GOLDMAN SACHS & CO., NEW YORK, N.Y.

[Complete statement follows:]

STATEMENT OF PHILIP C. SCOTT

GOLDMAN, SACHS & CO.

BEFORE THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

September 22, 1983

Good morning. My name is Philip C. Scott. I am a partner of Goldman, Sachs & Co., an investment banking and securities firm founded in 1869 and a major underwriter of, and dealer in, fixed-income securities of all types, including mortgage-related securities. I am here today to testify on behalf of Goldman Sachs regarding S. 1821, the Secondary Mortgage Market Enhancement Act of 1983, whose objectives we wholeheartedly support. We have some technical suggestions regarding Title I that we believe would improve the bill. We also have some reservations relating to certain peripheral issues that we believe could be deleted from the bill's coverage without any harm.

I won't take time to urge upon you the importance to our national economy and to men and women across the country of doing everything we can to broaden the available sources of credit for housing. We believe S. 1821 is a significant step in this direction.

Our first technical suggestion is quite specific in nature. Section 106 of the bill amends Section 4(5) of the Securities Act of 1933 to broaden the permissible range of institutions that may originate mortgage-related securities entitled to the benefits of the bill. In addition to depositary institutions of every kind, the bill covers insurance companies and then extends coverage to "similar institutions" subject to federal or state supervision and examination. Certain mortgagees approved by the Secretary of Housing and Urban Development are also covered.

We believe the bill should leave no doubt that registered broker-dealers such as Goldman Sachs are also eligible originators of exempt mortgage-related securities. Goldman Sachs, for example, is subject to examination and supervision by the Securities and Exchange Commission, numerous state securities authorities, the NASD, the New York Stock Exchange and numerous other regulatory and self-regulatory agencies. We believe broker-dealers such as ourselves should be entitled to equal treatment under the bill.

Second, we believe it is time to move the mortgage-related security exemption from Section 4 of the Act to Section 3 of the Act. Section 4 of the Act deals with so-called "exempt transactions", and it is not immediately clear why mortgage-related securities that are described in such detail do not better belong in the "exempt securities" section of the Act, i.e., Section 3. The important consequence of the shift would be, quite frankly, to relieve sellers of these securities of potential civil liability to purchasers in the event that losses are allegedly suffered as a result of incomplete disclosure. Mortgage-related securities are not like corporate securities for which there is a "due diligence" pattern of many years' standing. Rather, they are packaged on the basis of sellers' representations, negotiated servicing arrangements and widely differing paydown and other assumptions. The institutional purchasers of the securities covered by S. 1821 do not need recourse under the securities laws against the seller in the case of misunderstandings or good-faith errors. Of course, moving the exemption from Section 4 to Section 3 would preserve any buyer's right against a seller guilty of fraud or similar misconduct. We think the change would encourage additional supply of housing-related credit by more closely matching sellers' potential liabilities with buyers' realistic expectations.

S. 1821 deals with two issues that we believe have no place in the bill. The first is shelf registration of non-exempt securities. The SEC has ample rulemaking authority to permit shelf registration if it sees fit to do so. We are on record as opposing shelf registration of corporate securities as tending to subject buyers to undue pressure to make immediate investment decisions on the basis of insufficient information. While shelf registration of mortgage-related securities does not present the identical problems, we see no need for the Congress to mandate a particular registration technique when that kind of decision has always been left to the SEC. The second provision that we believe has no place in S. 1821 would amend the Glass-Steagall Act to allow national banks to underwrite and deal in mortgage-related securities. We believe encroachments on Glass-Steagall have already gone too far on a case-by-case basis without Congressional guidance. The appropriate role of banks in regard to mortgage-related securities should await a comprehensive review of this area.

Regarding the pre-emption of state securities and legal investment laws, we would observe that pre-emption is a technique that should be employed only in extreme circumstances. However, the difficulties of co-ordinating national policies such as the promotion of mortgage-related securities with a multiplicity of state requirements are such, we believe, as to justify the approach taken by the bill.

Finally, we doubt the wisdom of dictating to the SEC the manner in which mortgage-related securities should be treated for net capital rule purposes.

With regard to Title II, we support sections 203 through 205, expanding the operational authority of Freddie Mac to purchase manufactured housing loans, to purchase mortgage loans insured by State housing finance agencies and to purchase loans secured by junior liens.

A~~lthough it may not be germane to the legislation before you~~, We would also recommend that the FNMA Charter Act be amended to:

- reduce the loan to value restrictions on FNMA multi-family mortgages

- remove collateralizataion requirements and term restrictions on FNMA loans on the security of mortgages
- permit FNMA to offer limited voting rights to the holders of preferred stock
- expand the FNMA board of directors to a total of 18 by adding three new shareholder elected directors
- simplify and expedite various operational and oversight procedures between FNMA and HUD as outlined in H.R.1, the House housing authorization bill.

We would also strongly recommend that the committee approve some liberalization in the maximum loan limits eligible to be purchased by both Freddie Mac and Fannie Mae. While the current limit of $108,300 may be consistent with the broad aim of directing federally sponsored agency support of housing away from the middle class and the upper middle class, it may in the long run jeopardize the credit standing of Freddie Mac and FNMA and their securities by arbitrarily depriving these agencies of access to the most creditworthy home borrowers. We would support some formula approach to increasing this limit on a regular basis.

Finally, although we do not comment specifically and in detail on S.1822, we approve of the general objectives of the legislation in that it would tend to increase funds available to the housing industry.

In conclusion, I would like to stress our support for the bill's objectives while at the same time asking you to consider carefully our technical and other comments.

Senator TOWER. Thank you very much, Mr. Scott.

I'd like to ask each of you gentlemen to comment to my question.

IMPACT OF EXTENSIVE PARTICIPATION BY THE PRIVATE SECTOR

In your view, would extensive participation by the private sector in the secondary mortgate market have any kind of significant hedge against the disintermediation that has so often characterized the bust side of the boom-bust cycle in the housing industry?

Mr. RANIERI. To the degree that we can create a more liquid market and to the extent that S. 1821 and S. 1822 were both passed, S. 1822 again being a bill which would provide enormous structural flexibility, we could employ the types of structural mechanisms that would make housing much less subject to the boom or bust cycle as a function of the movement of rates.

Currently, it is very difficult when interest rates go beyond a certain point, given the limited structural flexibility we have now, including the limited structural flexibility that the agencies have, to employ techniques or structural mechanisms that create mortgage affordability. If you look at the problem, I would cite as an example Freddie Mac's first CMO, its collateralized mortgage obligations, which was eminently successful but was difficult to create because of our limited structural flexibility, I believe S. 1821 and S. 1822 would have significant ability to limit the boom or bust cycle.

Senator TOWER. Mr. Fink.

Mr. FINK. I think the mortgage-backed securities market since 1970 has helped reduce the problems of the cycle. I would even make the statement that if it were not for the changes made by the Bank Board in late 1981, and some additional changes in 1982, the problems of the thrift industry would be more severe. In regard to S. 1821 and S. 1822, and to continue what Mr. Ranieri was saying, the changes in S. 1822 specifically are going to, in my mind, reduce the problems of boom-bust cycles tremendously in regard to the availability of money.

The problem historically has been that mortgage-backed securities are long-term obligations. With S. 1822 the freedom of creating new streams of income and new maturities for mortgage-backed securities, we are going to be able to tap capital markets that mortgage-backed securities have not been able to tap in the past. You will be able to create maturities with 2-year final maturities, 5-year final maturities, and 10-year final maturities. That is very significant, and it's particularly significant with respect to the shape of the yield curve.

If the Treasury yield curve once again becomes quite inverted, we will have real problems in accessing long-term pools of money because everybody's lending only short-term due to the much higher yields. With the freedom provided by S. 1822 we will have access to these pools of capital. The price of money may be higher, but there will be a much wider and greater distribution of money going into the housing market during this period.

Senator TOWER. Mr. Pratt.

Mr. PRATT. First, I would say that there's a lot of evolution taking place. The kind of boom-bust that we saw in the 1960's and early 1970's I don't expect to occur in the same magnitude again in any case because of the deregulation of the financial institutions.

Under regulation Q, when interest rates went up, money was cut off from those institutions. I believe in July 1966 when interest rates went up, the commercial banks, S&Ls lost a billion or two billion dollars. Housing starts went in one month from 1.6 million to 800,000 units. We're unlikely to see that sharp of a turnon-turnoff of the housing market again.

The deregulation has made price the ration rather than the availability. The very high rates that we saw in 1981 and 1982 were to some extent a function of the very types of things we're talking about today, imperfections in the capital market. We saw mortgage yields in places 300 or 400 basis points higher than Treasury's during that peak and that was mainly, in my opinion, because of imperfections in the capital markets that provide mortgages.

Even with the evolution we've seen today we have seen mortgage-backed securities trade within 100 basis points of Treasury's and again Freddie Mac's CMO, even the highest yielding portion of it as I recall, was about 85 or 86 basis points over Treasury's.

As you can make a better, more efficient market, turn these into securities in a more efficient fashion, mortgages are not going to be penalized nearly as badly in the adverse part of the cycle and they are going to be able to stay in and compete much more effectively. They will be able to access the shorter terms, as my companions here have spoken of. This bill should go a long way to alleviating the imperfections in the capital markets and some of the boom-bust problems.

Senator TOWER. Mr. Scott.

Mr. SCOTT. I would echo Mr. Pratt's remarks about deregulation. Clearly, disintermediation has had its impact through thrifts and through regional banks. Federal agencies have relieved that impact by providing sources of funds when the thrifts and regional banks came up short. Deregulation will further relieve that impact by providing access to money market deposits which thrifts and regional banks have not had. Greater access to the mortgage market through private companies will further relieve the impact—not necessarily through working with the thrifts and the regional banks—but probably by bypassing the traditional sources of mortgages, taking it right from the homeowner straight to the market; and, significantly, by taking it to the market in different maturity structures than has heretofore been the case because we still, after all the experimentation that we've gone through, basically have 30-year mortgages.

Senator TOWER. Thank you.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

ESTIMATED PERCENTAGE OF THE MARKET

I would be interested in hearing the witnesses' view on the development of the private secondary mortgage market assuming this legislation goes forward along these lines. Where are we likely to be in terms of the growth on the private side 5 years out and 10 years out? What percentage of the total market do you think you and others will compete for and win in terms of market shares in the next decade?

Mr. RANIERI. Well, I think the first significant result of S. 1821 and S. 1822 would be the going forward—in terms of entering into the market—of many of the larger private sector entities. I know, speaking for my firm, that we are currently working with seven major institutions, all of whose names you would be very familiar with, representing commercial banks and insurance companies who would enter this market. The reason they are not in it already is that—as I described earlier—it's a very difficult market to do business in currently. As I did not have the benefit of hearing the testimony yesterday on the part of RFC and GE, I know that it was very expensive for them to enter into with no guarantee of success.

So I think the first thing you must take into consideration in answer to your question is that you would have these players because it would be evident to them that the market could exist. The forces of competition would be much greater and the problem of, let's say, two or three principal entities now trying to cover the whole country would disappear. You should have many new entities covering the whole country.

I think you must also recognize that the capital markets have shown an astounding ability to absorb the mortgage security product. As an example, my firm distributes something between $13 billion and $15 billion a month of mortgage securities, overwhelmingly governmentized, but it's still absorbing that kind of volume. Many of the securities the private sector could create would be AAA rated and therefore should be as absorbable by the capital markets.

Overall, I would see a process, first, of increased competition, and second, of greater penetration across the country because of the number of players and the diversity of the nature of these players. The third thing that I think is very important is that, given the nature and the number of these new players, the cost involved to everyone in doing business would decline dramatically.

One of our problems now is that even if you assume that the difference in the cost of funds in the capital market between a Freddie Mac, a Ginnie Mae and a private entity like RFC is 20 basis points, it still doesn't translate into a mortgage cost differential of 20 basis points. Because of the inefficiencies in the market, private sector issuers incur much more expenses in terms of insurance fees and items like that. So 20 basis points still turns into 50 basis points.

Many of the benefits of this legislation could change this relationship and so the relative cost of funds would translate much more closely into the relative market rates between the two sectors. And I think easily with a 5-year period you would have a meeting again to determine if the private sector could now share a burden which was currently being shared with the agencies. I don't think that unless you pass some other type of regulation such as giving TIM's to the private sector and not to the agencies that the private sector could beat the agencies. In other words, could they generate a lower cost of funds than the agencies?

Senator RIEGLE. Preston Martin has estimated 10 to 15 percent of the market 5 years out. Would you tend to agree with that?

Mr. RANIERI. In fact, I would tend to believe it's slightly low. Given where we are now with as many handicaps as we have now, and my belief about the credit strength of some of the entities entering the market, I would say that the number might be 20 percent as an example rather than 10 to 15. That's assuming again you don't extend the power to the agencies which is turning it back the other way.

Mr. FINK. I think S. 1821 and S. 1822 will allow private issuers to act as viable and profitable conduits of mortgage securities.

I would also like to state that within the next 5 years, provided both bills are passed—I foresee a role for both private issuers and the agencies in a very significant way. The private issuer is going to be very responsive in creating relatively small customized types of securities, that many private and public pension funds, as well as city and county governments will be interested in purchasing.

I also believe that within 5 years the private sector, with these new freedoms and with the potential reduction in cost because of the changes, will exceed a 25-percent market share. I think there's a big role for the private sector in this issuance on a customized basis, and I still see a very large role for the agencies. The agencies must be there to provide, as I say in my testimony, a fungible market; but many private institutions really don't need a fungible security. They need to buy something specific for their investment needs and for the specific needs of their pension accounts, and this is where I see the private issuers going forth, and taking a big role in the mortgage-backed credit markets.

Senator RIEGLE. Could I ask you a question along that line? Do you think the mix of mortgages will fall proportionately across the spectrum from less expensive housing up to very expensive housing? In your view will there be a skew in that profile? I would be interested if the others have a thought on that too.

Mr. FINK. I think there will be a skew because I don't believe we will see the public pension accounts really subsidize the jumbo mortgages. I still believe the freedom that will be allowed by S. 1821 and S. 1822 is going to move funds into the lower and lower middle income housing structure. I do believe the added securitization and the innovations taking place in the market will result in additional investments in these jumbo type mortgages, which I applaud. But I still believe we will see the prominent and dominant areas of investment by security holders in small mortgages that will fund lower and lower middle income housing.

Senator RIEGLE. Mr. Pratt.

Mr. PRATT. First, I think even at the present time we are seeing tremendous new initiatives by private market making firms into the mortgage markets. Our firm's additional commitment to mortgage product and those who provide mortgage product, is an example. Other firms are also moving in this direction.

UNEQUAL POWERS AND CREDIT STANDING

The balance between the private and public market is going to depend very heavily on legislation, among other things. At the present time, we have unequal powers and unequal credit standing. That is, the Federal agencies have superior powers in having many of the benefits of S. 1821 especially and at the same time have implicit Federal credit backing. So, at the present time, they have both credit and operating advantages.

With the passage of these two bills, we would equalize the operating situation to a very substantial extent. I would think that that would cause a tremendous increase in the private market sector, maybe doubling or tripling what would occur in the absence of that sort of situation.

Depending on what new credit areas or authorities agencies might be allowed in, beyond where they are now would tremendously affect what is in the private market and what is in the public market.

Also, we should not overlook the areas where the two work together on a very substantial volume. In fact, Mr. Fink's firm I think would be an example recently of that where a large institution on the west coast is selling $1.6 billion of mortgages, a combination of these, to Freddie Mac and First Boston in that transaction. So there are private transactions; there are combination transactions; and there are wholly agency transactions.

Senator RIEGLE. Mr. Scott.

Mr. SCOTT. Senator, I guess I'm not as comfortable as others have been in making that kind of forecast. I do know that there are substantial institutional investors that we deal with who are frustrated by their inability to diversify their portfolio of mortgage-related securities away from these two agencies, and that giving the private sector these powers will go a little way toward meeting that appetite. But these decisions tend to be reflected at any given moment in time on credit perceptions and yield perceptions and the tradeoff between them, so it's hard for me to judge whether they are looking upon the agencies 1 or 2 years from now as more or less creditworthy vis-a-vis the private sector.

I think probably more important is the point Larry Fink raised in his testimony—it's the maturity diversification. Once you start to really give the private sector the ability to open up and package a lot of mortgages—with the inventiveness of the capital markets and these participants—you can take 30-year securities and package them and repackage them into 2-year securities. Then what you have done is you're not just providing product to the traditional mortgage investor but you're providing product to the nontraditional mortgage investor, and that may turn out to be the key to the extent to which the bill is effective.

If you look at the average maturity of Fannie Mae debt or Freddie Mac debt or the Nation's debt itself, you come up with something closer to 2 or 3 years, not something closer to 20 or 30 years. And that's where the great bulk of the investing is done and the CMO is one of the first and most innovative moves I've seen in that direction. I think that will probably have the largest impact in really determining what percentages of funds are available to this private sector.

SAVINGS FOR THE TYPICAL MORTGAGE BORROWER

Senator TOWER. Mr. Ranieri, what will S. 1821 save the typical mortgage borrower and how much if S. 1822 is added?

Mr. RANIERI. As I said, Senator, S. 1821 primarily deals with the ability of the private sector to do business. The existence of the private sector in the nonconforming area has already brought down mortgage loss to borrowers. I think that is demonstrable by simply looking at the cost of nonconforming loans prior to 1981—which is the most viable private sector year—versus today. That rate has already declined by 50 basis points.

In terms of additional savings, I think that it is hard to pin down the effect of S. 1821, simply because it's S. 1822 which affects rate and S. 1821 which enables you to do business. The sheer fact that you can do business brings down rate, but can we say it's 25 basis points? It may very well be. I would tell you, Senator, and I believe that the effect of S. 1821 and S. 1822 collectively, without talking about the effect of one or the other, as they are really companion bills—would collectively save 50 basis points versus where you are, one-half of 1 percent. But it's hard to split them up that way.

Mr. **Pratt**. Mr. Chairman, just to follow up on Mr. Ranieri's comment, even if it were only 12 or 13 basis points, that really translates into 1 percent of the value of the mortgage. So if S. 1821 could save 12 or 13 basis points, that would be the same as almost writing a check back to the home buyer eventually of 1 percent of the purchase price of his house or 1 percent of the amount of the mortgage at least.

So even though we're talking a few amount of basis points possibly, we're talking immense sums of money and immense benefits to the transacting public.

Senator **Tower**. Mr. Fink, in your view, how many new entrants to the market will S. 1821 bring in?

Mr. **Fink**. That's a difficult question.

Senator **Tower**. It might be difficult to quantify that.

Mr. **Fink**. I think those in the private sector who desire to enter the market now have the flexibility to do so. It's still going to be a question of cost and relative value versus the agencies, to determine if the private sector can compete. I believe Mr. Ranieri has ready six or seven and my firm has about five or six issuers ready to go.

I think it's going to be almost like a herd instinct as we see so often in the securities market. If one firm becomes successful and makes money on it, there are going to be four other firms that are going to try the same technique, maybe modify it, improve it. That's just a function of our society and our economic base. I believe we are going to see more than I could even estimate today, because I think it will be a successful process. For me to give you a number of 10 or 25 would be something that I would be drawing out of the air, but I do believe we are going to see the first few entrants be successful, which is going to open the eyes of other potential participants to the potential in the marketplace.

Senator **Tower**. Do any of the others care to comment on that one?

[No response.]

PRIVATE SECTOR RELATIONSHIP WITH FNMA AND FHLMC

Senator **Tower**. Let me ask all of you to respond to this one. What is your business relationship to Fannie Mae and Freddie Mac and how many nonagency issues have you managed?

Mr. **Ranieri**. Salomon Bros. is comanager on virtually every Fannie Mae issue. We have been leader or comanager on every Freddie Mac issue. We have managed or comanaged every public mortgage backed security ever done with the exception of two, and those were managed by my compatriot here, Larry Fink. So we have been significantly involved in virtually every transaction in the capital markets, whether with the agencies or with issuers from the private sector, including private placements.

Looking at publicly available data, we have done as many mortgage security issues by ourselves, I guess, as all of our competitors together.

Mr. **Fink**. First Boston's relationship with the two housing agencies is quite similar to our relationship to other governmental agencies, and also our relationship to the Treasury itself. First

Boston has been comanager or lead manager for all issues by Fannie Mae and by Freddie Mac—the same position as Salomon Bros. We are presently, along with Salomon Bros., and Merrill Lynch, managing a $700 million CMO for Freddie Mac—which has just been announced this morning. Two weeks ago Salomon Bros. and First Boston were financial advisers to Fannie Mae on a $300 million mortgage passthrough.

We are also financial advisers and managers to many, many private sector institutions. Our role at First Boston is that of financial adviser. The information that we are imparting to an agency, be it a housing agency, or the Home Loan Bank, or the Treasury, or OMB, or an S&L on the west coast is that we are advisers and we're going to be trying to provide the best information, both economic and financial, that we can provide. So we have equal hands in the private sector and the public sector.

Mr. Pratt. The particular entity which I head is a fairly new entity and so it doesn't have the record with the agencies that the two firms to my right does. Merrill, of course, seeks to be an investment banker to the agencies. We are involved as a comanager on the Freddie Mac deal which was announced this morning and that is a line of business we seek, along with our seeking to serve the private sector in this area.

Mr. Scott. We have participated in the Freddie Mac and Fannie Mae passthrough distributions and managed or comanaged a number of private passthroughs. I'd say our general level of participation in the whole market is less than that of Salomon Bros. or First Boston, but the participation is broadly based in both the private sector and the agency sector.

STRICT STANDARDS ON THE QUALITY OF MORTGAGES

Senator Tower. Let me ask you all to comment on this. Mr. Martin raised some concerns that S. 1821 needs to establish more strict standards on the quality of mortgages. What are your views on the need for quality standards and on the effect of the current requirement for a rating of securities?

Mr. Ranieri. I echo Mr. Martin's concern and in my written testimony I allude to the fact that the intent of the legislation is laudable but, in fact, it may have gone too far in not including appropriate restrictions. As an example, I believe that I allude to the fact that maybe you want to require an investment rating—one of the top three investment ratings as an example—in order for a mortgage security to qualify for the exemption provided by S. 1821. So I'm in complete agreement with Mr. Martin's concern and I think that, given the importance of this legislation and the importance of the effort in general, that it is much more important to err on the side of caution in terms of what is allowed than on the side of expansion.

Senator Tower. Mr. Fink.

Mr. Fink. I would have to agree with Mr. Ranieri and with Mr. Martin, but I would also like to add that the marketplace is a free enterprise, and if there is an investment grade of single B—I can't even fathom what kind of quality of mortgage that is, by the way—but if there is such an animal, the marketplace is going to price it accordingly, and it may just price that security out of the marketplace. If it doesn't, well, once again, it will be priced at a substantially higher yield level than a higher investment grade security such as a AA or AAA. The marketplace will ferret out quality quite rapidly, but I think we have to have some limits. I think the marketplace as it's been operating does a very efficient job in ferreting out poor quality types of assets and investments.

Mr. Pratt. Some quality restrictions may need to be imposed, but I think they should clearly be performance oriented and not biased so as to make it only possible for firms such as ours and those seated at this table to issue these securities. It should be something which benefits a very wide range of market makers and which is generally accessible to market makers and the quality aspects should be related to performance, not so much to what the firm looks like that may be involved in it.

I would also support what Mr. Fink has just mentioned. I think we should encourage the diversity of initiatives and the ability to generate mortgage backed securities of various qualities. It seems to me one of the weaknesses of this market, in addition to the single maturity—that is the long-term maturity nature of it—is at the present time it's an immature market and it's only penetrated the highest quality levels. As it matures, it should be able to produce what we would call junk bonds or bonds and securities of lower quality ratings through a mixture of various mechanisms and I don't think that ability should be preempted by legislative approaches.

Mr. Scott. Mr. Martin mentioned the two top categories, AAA and AA. If you look at the history of corporate debt in this country, there's been a growing absense of AAA issuers and, for all practical purposes, if you adopted those two standards, you would end up with AA and a very small handful of AAA issuers. Most investment grade definitions go right down through single A through BBB, and I think most institutions can handle all four grades.

Mr. Pratt, when he changed the regulations at the Home Loan Bank, sought a higher standard or a higher permissible investment amount in higher quality issuers as opposed to lower quality issuers, and that thesis may be a good thesis.

But I have great difficulty in only using the top two categories. Most corporate America today is single A. There's only a handful of the AAA and even if you look at AA's, it's less and less. A surprising number of companies that do business in the marketplace every day are BBB and most institutional investors are perfectly able to deal with them.

ADVANTAGES AND DISADVANTAGES OF FNMA AND FHLMC

Senator Tower. Let me ask each of you to respond to this question. What are the advantages and the disadvantages of Fannie Mae and Freddie Mac participating in the TIM-type securities?

Mr. Ranieri. The obvious advantage of Fannie Mae and Freddie Mac participating is that since—at least speaking for myself and my firm—we believe that S. 1822 could be a very powerful piece of legislation which has within it the power to lower the mortgage rate, that by not giving it to Fannie Mae and Freddie Mac you would not be allowing that cost savings to the portion of the market they service.

Second, we have always looked toward Fannie Mae and Freddie Mac to set the standard for the rest of the industry. As it was, Ginnie Mae was the flagship behind which Freddie Mac followed and then Fannie Mae. I think you could look to the agencies for leadership. If you do not give it to them, you have the potential to have the private sector outprice the agencies. In respect, you're really talking about a political effect—do you wish to use the TIM mechanism as a method to curtail the power of the agencies? I think largely that would be the result.

It is perfectly conceivable to me that S. 1822, being as powerful in terms of rate saving as it is, if it is given to the private sector and not given to the agencies, that the private sector could in fact at that point conceivably compete with the agencies.

Mr. FINK. I would like to add a little more to what Mr. Ranieri is stating.

For 13 years the agencies have provided not only the standards for mortgage backed securities to the investment community, but also the backbone of the mortgage backed securities market. Mortgage backed securities' chief reason for investment is fungibility between one security and another, and one coupon versus another. We will not have that fungibility with S. 1821 or S. 1822. One private issuer will issue a TIM's like structure and another will issue another TIM's like structure.

The agencies will provide the backbone, I think, to the mortgage backed securities market, which is a necessity for the investments by our pension funds that are becoming increasingly dominant investors in mortgage backed securities. They need the liquidity associated with large agency issues.

To carry it one step futher, if the TIM's proposal precluded the agencies, I'm troubled that the housing sector of the economy will be at a major disadvantage. I think we are putting too much pressure on the private sector too rapidly. The private sector issuance of MBS's is an unproven sector. I believe it will be a very successful sector over time, but to give these powers to the sector immediately and to reduce or break the backbone of the mortgage backed securities market in one swoop would not be advisable; and it could have some severe effects on the whole housing market in America today.

Mr. PRATT. I may disagree a little with my colleagues that have just spoken. It seems to me, given the financial abilities of both Fannie Mae and Freddie Mac that they have most of the abilities that would be incorporated in this legislation at this time by issuing straight debt issues that are not directly tied to collateral and they could come out with whatever maturity and sets of conditions that they want. It seems to me that ability generates most of the abilities to structure what can be structured under the TIM's type of circumstance.

I think the real crucial issue here is that giving the full TIM's authority in S. 1821 and S. 1822 to the agencies without restrictions of any type would tend to very substantially expand the Federal presence in the mortgage market and would remove this fringe that is now the domain of the private market makers and would tend to stifle the development of that private market because it is very difficult to compete in product that qualifies for a Federal credit guarantee of some type.

So it seems to me that giving unrestricted access to that would be the same as a decision to remove most of the restrictions on value limitations and other factors that might now exist for those two agencies. It's really a very basic value question whether because of the cost advantages those agencies bring to the American public we want to push the federalization of mortgage credit further or whether we want to see if the private market can develop cost competitive mechanisms that don't involve the Federal credit guarantee. So I think it does resolve down to the question on the part of this body as to a private direction or a public direction.

Mr. Ranieri. Let me clarify, because I agree with Mr. Pratt completely. I was simply commenting on giving the agencies the TIM's flexibility but no additional increases either in loan limits or charter powers. If that were done, I would agree with Dick Pratt completely; you wouldn't need this bill because you would choke off the private sector completely. So please understand my comments in the context of simply giving them TIM's flexibility but no increase whatsoever in loan limits or charter provisions.

Senator Tower. Mr. Scott.

Mr. Scott. My testimony basically included increases in charter powers and I only referred to TIM's in terms of general support.

The one thing I would be most fearful of is if you have an institution that's over $70 billion in size and another institution that's originated over $50 billion in passthroughs and has $5 billion in mortgages on their own balance sheet, and if you start out a new venture without including them or permitting for their inclusion in the future in any way, shape or form, then you've basically jettisoning the entire history of passthrough support for the market in hopes of launching a brand new vehicle and in hopes it will be extraordinarily successful. If I didn't include the agencies in TIM's I would broaden their charter powers, as I said in my testimony, and would include some sort of formula increase in their current loan limits, and if I did include them and I was worried about them preempting the private sector, I would include them on a small basis. In other words, I wouldn't give them broad powers. I would give them very narrow powers. But I don't like making business decisions that just leap from something that's worked to something we've never tried before.

Senator Tower. Thank you very much, gentlemen. We're delighted to have you bring the real world of Wall Street to the rarified atmosphere of Capital Hill. It's been extremely helpful testimony and we thank you all.

The hearing is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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Attached to this memorandum are the following:

(1) a summary analysis of S. 1821, with general economic effects;

(2) a section-by-section legal analysis;

(3) a glossary of terms as used by securities analysts (rather than housing or mortgage analysts);

(4) a summary of the three basic types of privately issued, publically offered securities extant;

(5) an explanation of shelf registration procedure of the SEC.

This somewhat abbreviated package should provide some assistance in dealing with this particular piece of legislation. For the most part, we view the changes as facilitating a trend already under way rather than a radical break with past practice. We have not identified any practices which would impede implementation that could not be solved with promotional efforts. The major economic gains are limited to those of efficiency in dealing in mortgage paper and increased liquidity resulting from a larger scale of issues.

SUMMARY ANALYSIS OF S. 1821
SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983

INTRODUCTION

Mortgage-backed securities, in "pass-through" or bond-like form, are increasingly the preferred form for holding residential mortgages by diversified investors. Sharp interest rate cycles with their attendant profitability effects and legislation designed to loosen regulatory restrictions on the thrift institutions have increased the attractiveness of securities for these traditional, non-discretionary mortgage lenders as well, both as portfolio holdings and as a means of selling mortgage assets out of portfolio.

Issuance of mortgage-backed securities (MBS) has been dominated by the "Big Three" Federal and federally related secondary mortgage market institutions. The Government National Mortgage Association (HUD-GNMA) first issued pass-throughs backed by FHA-insured and VA-guaranteed mortgages in 1970, and was followed by the Federal Home Loan Mortgage Corporation (FHLMC) issuance of securities backed by conventional mortgages in 1971, and the Federal National Mortgage Association (FNMA) offerings, also backed by conventionals, in 1981. Although the first private issue of securities to be publicly offered was issued in 1977, most private issuances have remained "privately placed" rather than being offered to the to the general investor public under the registration requirements of the Securities and Exchange Commission (SEC). The result is that private MBS issues have only a "thin" market, are not actively traded, and lack the liquidity characteristics as well as the explicit or implicit Federal backing of Big Three issues.

Most current legislation affecting securities financing of residential mortgages falls into either of two catagories: the removal of regulatory impediments to trading in MBSs, or a broadening of interest by diversified investors in these securities. S. 1821, the "Secondary Mortgage Market Enhancement Act of 1983" mainly addresses the first of these goals. First, it facilitates the transformation of mortgages into securities which need not be issued, insured, or guaranteed by a Federal or federally related agency. It does this by expanding exemptions from SEC registration requirements, allowing purchase on credit, easing financial institution mortgage investment restrictions, and preempting State securities laws for issues. Second, it increases or clarifies FHLMC purchase and securities authority.

SUMMARY OF PROPOSED CHANGES, SECTION-BY SECTION

101. The exemption from SEC transactions requirements for large denomination securities issued by Federal- or State-supervised financial institutions is expanded to include MBSs backed by second loans, cooperative housing loans, and manufactured housing loans, in addition to already covered first liens. Mortgage-related payment bonds (not directly secured by mortgages) are also exempted. HUD-approved mortgagees (principally mortgage bankers) are added to savings and loan associations, savings banks, commercial banks, credit unions, insurance companies and similar Federal- or State-supervised institutions as eligible issuers of MBSs under the exemption. The time limit allowable from a purchaser's commitment to purchase securities to payment is increased to four months (the limit is currently two months). The minimum transaction amount necessary to receive registration exemption ($250,000) is clarified to apply only to the first securities sale and not resales. This takes into account the reduction of a security due to the regular return of principal on the mortgages

in the underlying pool. These changes basically narrow the differences between the MBS offerings of the affected private institutions and those of GNMA, FNMA, and FHLMC, which have blanket exemptions from SEC registration requirements. The exemptions are only for large denominations issues, which are unlikely to be traded by other than institutional or highly sophisticated investors. Exemption may not extend to issuances by some non-supervised institutions (some insurers and conduits).

102. Private securities may be purchased on credit (margin) from broker-dealers on the same basis as government agency securities (e.g. GNMA's).

103. Net capital requirements of securities dealers holding MBSs in inventory are reduced to those of comparable maturity government securities where the securities are "investment grade" (Aaa, Aa, A, Baa in Moody's bond rating system).

104. Federally chartered thrift institutions and credit unions are allowed to invest in private MBSs subject only to limits imposed by their appropriate Federal regulators. Currently, for example, credit unions are restricted to MBSs which are guaranteed by the Federal Government (GNMA's) or issued by FHLMC. This change does not automatically mean that FNMA or private MBS issues would become allowable investments for credit unions under this change; that would be up to the National Credit Union Administration (NCUA).

105. National banks are allowed to underwrite, deal in, and purchase for their own account, private MBSs subject only to limits imposed by their Federal regulator. Currently, National banks are limited on MBS purchases from a single issuer (to no more than 15 percent of unencumbered assets and surplus). The banks already underwrite and deal in GNMA-guaranteed securities and mortgage revenue bonds. They may not deal in non-MBSs issues.

106. State legal investment laws are preempted for investment grade private issuer MBS public offerings (registered). That is, State regulated institutions and trusts may invest in such MBSs. States have two years to override this preemption should they wish to do so. The importance of this preemption is that issuers can reach a national market by satisfying only SEC disclosure requirements instead of meeting the varying investment requirements of individual States. On the whole, States have stricter limitations as to what may be sold within their borders than the SEC, which only requires disclosure of all relevant information and not that securities be of any particular value or conform to any particular design. GNMA securities, as full faith and credit obligations of the Federal Government, are already beyond State laws. FHLMC has an exemption from State restrictions in Federal law which will expire in 1985. FNMA has no such Federal override, but has obtained exemptions on a State-by-State basis. FNMA counsel has indicated that their exemption is not complete in some States.

107. The experimental "shelf registration rule" due to expire at the end of 1983 is extended permanently for mortgage-backed securities described in the transactions registration exemptions section (but without regard to the minimum transaction size of $250,000). Shelf registration procedures simplify filings for private issuers who routinely pool mortgages to back securities to be publically sold, where the pool characteristics do not change much from issue to issue. Shelf registration also allows issuers to time the sale of securities to coincide with favorable market conditions by allowing sales "off the shelf" up to two years after SEC approval.

201. A technical amendment to the FHLMC charter which may allow already authorized issuance of preferred stock by the corporation, thereby enabling an increase in FHLMC's capital base and an expansion of activity.

202. FNMA is allowed to issue preferred stock (technical corrections to preexisting authority).

203. FHLMC is authorized to purchase junior liens (second mortgages). FNMA already has this authority, and both GNMA and FNMA and--under Title I of this Act--other financial institutions may issue MBS backed by seconds.

204. FHLMC is permitted to purchase mortgages on manufactured houses even where the home is not considered strictly real estate but may be mixed personal and real property.

205. State agency insured mortgages are eligible for FHLMC conventional mortgage programs.

206. FHLMC is prohibited from guaranteeing securities issued by other institutions. FNMA is not allowed to do this either, making GNMA the only Federal or federally related agency which may guarantee others' issues. Private issuers may obtain private company insurance on their MBSs (backed by conventional mortgages) but may not get such insurance from the FNMA or FHLMC.

SUMMARY OF ECONOMIC EFFECTS

By easing SEC registration requirements, this Act facilitates private issuer mortgage-backed securities issues and may make them more competitive with the issuances of FNMA and FHLMC. It is not necessarily true that the proposed changes will increase funds for housing relative to what would otherwise occur. That claim is based less on the notion that mortgage paper will suddenly become relatively more popular with investors than other investments, than on the idea that traditional holders of mortgages, which are diversifying in response to economic conditions and legislative and regulatory changes, will be replaced by traditional holders of securities--that latter group now holding mortgage-backed as well as other securities.

Nonetheless, the supply of mortgage credit overall could increase (at any given interest rate) if the issuance of MSBs exceeds the decline in direct mortgage investments. The extent to which this happens depends on the degree to which holding or trading mortgages in security form is more efficient for holders than straight mortgages. This efficiency is a function of risk spreading, homogenizing of mortgage investments, and increases in liquidity as the amount of tradable issues rises toward a point to become attractive and profitable for market makers. The risk advantage (particularly for issues backed by large pools) comes because the MBSs substitute the superior credit of the issuer for that of individual mortgage borrowers while securing the issue with more than the issuer's credit. Homogeneity is likely to be greater for MBSs than individual mortgages even though pools may differ in their characteristics. As the volume of MBSs traded increases, this will also give them a desirable level of liquidity. Increased volume will only come with time as discretionary investors learn about, and are attracted to, MBSs and as any particular regulatory impediments are removed from MBS investments. Aside from scale considerations for liquidity, economies of scale may occur if large, more frequent issuers have lower administrative costs per pool. This effect may be minor, however, as some conduits believe they already have costs as low as those of the federally related companies.

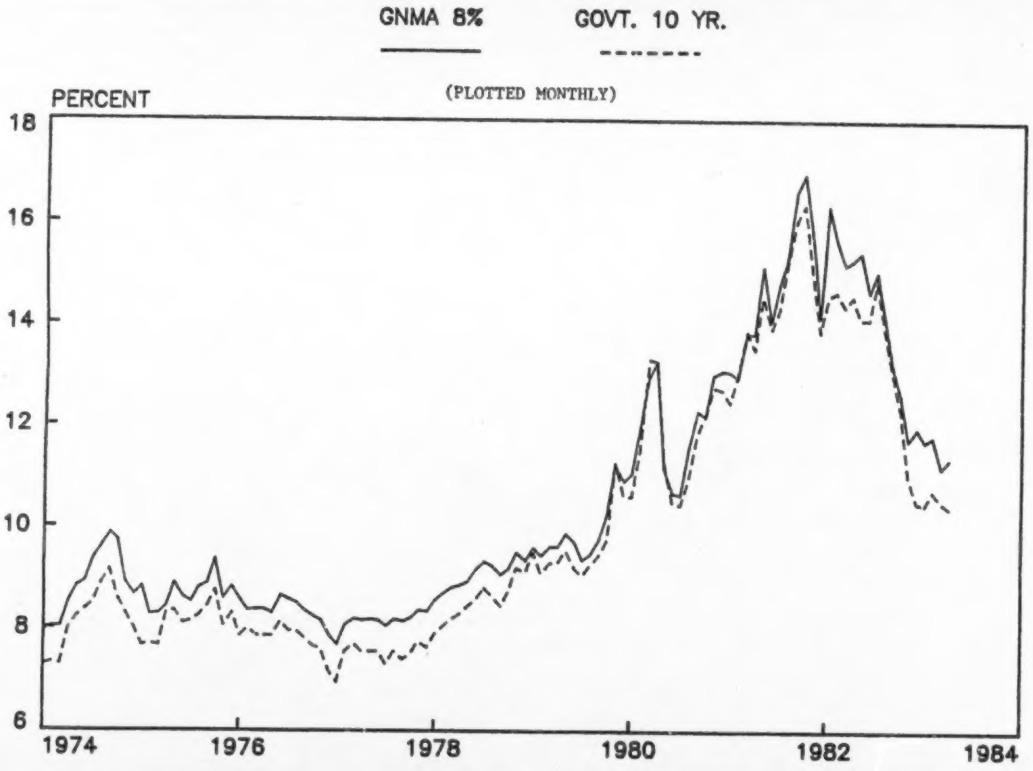
In economic terms, any increase in housing credit other than that due to greater efficiency would imply a subsidy or advantage to securities covered by the law relative to other instruments traded in securities markets. Such a subsidy would raise issues of "crowding out" of non-favored investments. To the extent such subsidies already exist (e.g. the deductability of mortgage interest) changes which create added efficiency or marketability for housing finance also increase the effectiveness of the subsidies in attracting funds to housing.

Ultimately, the limit on funding for housing is determined by the demand for mortgage financing at any given interest rate. That demand is dependent upon consumer ability or willingness to pay the interest rates required by investors in mortgage paper and is derived from the primary demand for homeownership (in turn dependent upon prices of houses and the ability to finance from both wealth and debt). So long as mortgage interest rates are free to rise to market-clearing levels, shortages of funds for housing, in an economic sense, will not occur, regardless of financing forms. This is a different situation from that of recent years where legislated market rigidities resulted in supply discontinuities (e.g. usury ceilings, deposit rate ceilings at non-discretionary mortgage lenders). Deregulatory legislation has already removed the more obvious of such rigidities.

The absence of economic shortfalls of funds for housing does not preclude lower levels of housing investment than desired as a matter of public policy. Neither does it mean that housing cycles will cease to occur, or that removal of SEC, pension fund (ERISA), and tax (TIMs) impediments to general housing access to credit markets will reduce such cycles. It may mean simply a return to mortgage cycle patterns of the pre-1966 period, when mortgage lending fell mainly because of moderate reductions in lending by diversified investors rather than sharp drops due to loss of loanable funds by non-discretionary lenders.

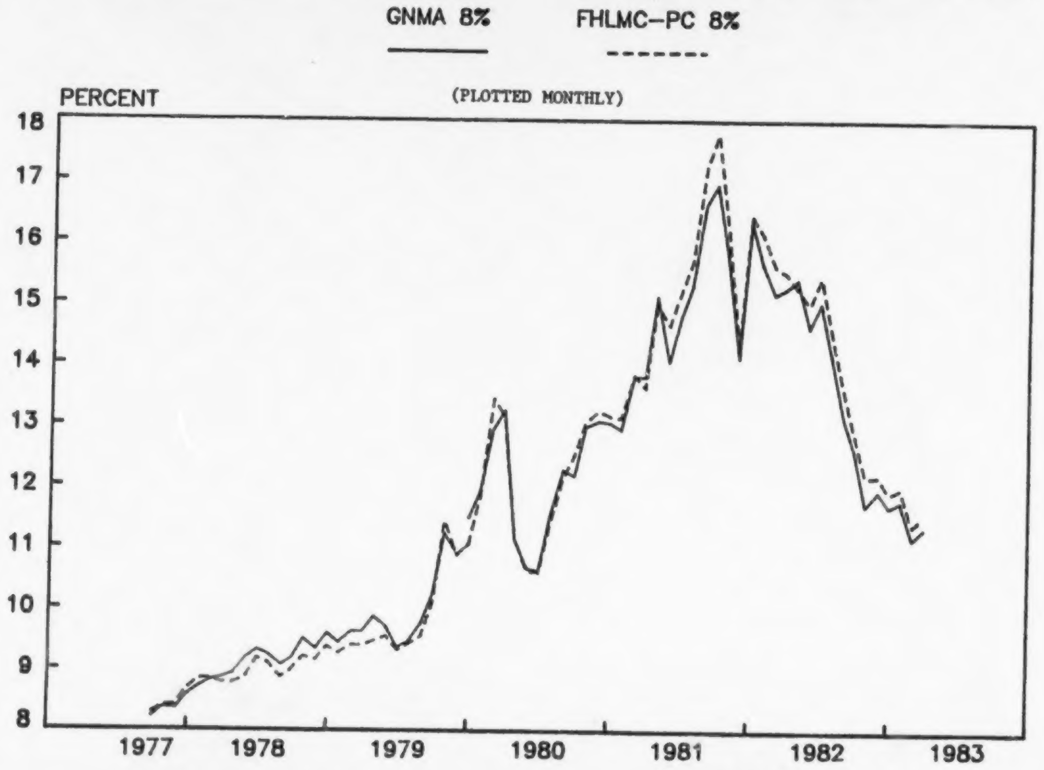
Barbara L. Miles
Specialist in Housing
Economics Division
September 15, 1983

YIELDS OF SEASONED GNMA 8% BONDS VS. US GOVT. 10 YEAR INSTRUMENTS



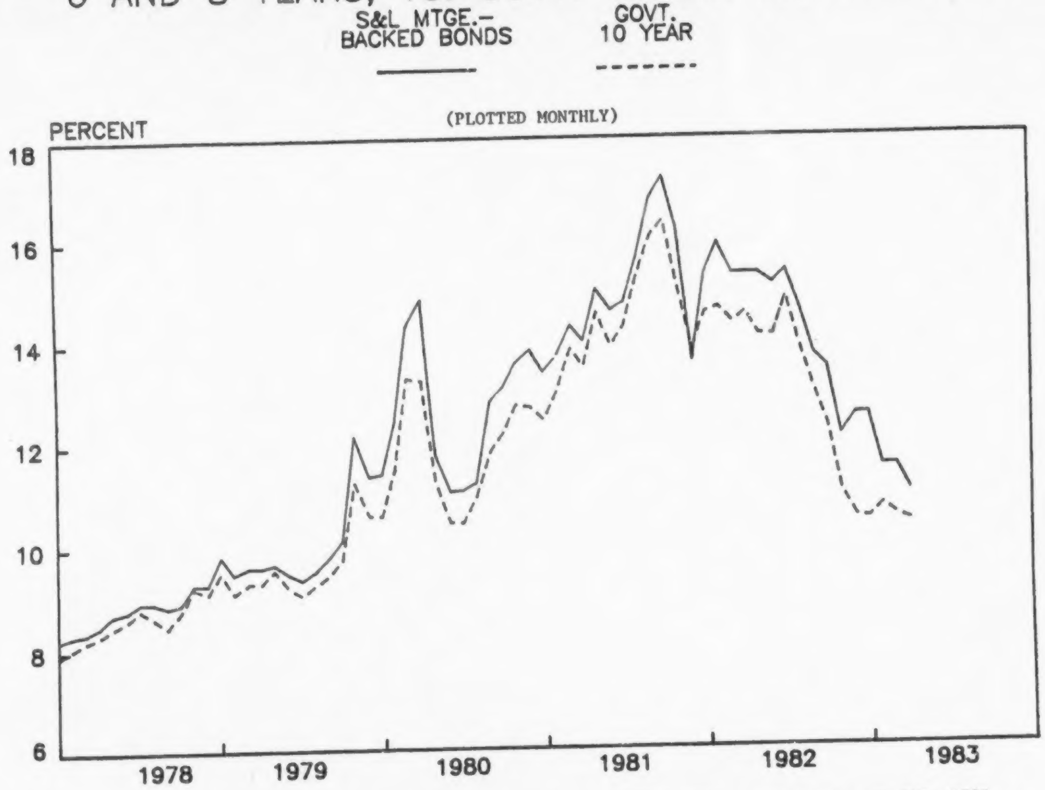
SOURCE: SALOMON BROTHERS, INC. CHART PREPARED BY CRS.

YIELDS OF SELECTED MORTGAGE INSTRUMENTS
(SEASONED GNMA 8% vs. SEASONED FHLMC–PC 8%)



SOURCE: SALOMON BROTHERS, INC. CHART PREPARED BY CRS.

YIELDS ON SEASONED S&L MORTGAGE-BACKED BONDS, 6 AND 8 YEARS, VS. GOVT. 10 YR. INSTRUMENTS



NOTE: MATURITIES ON S&L MORTGAGE-BACKED BONDS CHANGE FROM 6 TO 8 YEARS IN JAN. 1981.

SOURCE: SALOMON BROTHERS, INC. CHART PREPARED BY CRS.

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Washington, D.C. 20540

LEGAL ANALYSIS OF THE EFFECT OF S. 1821, 98TH CONGRESS, THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1983, UPON CURRENT LAW

S. 1821, 98th Congress, is intended to be a "comprehensive secondary mortgage market bill designed to encourage a broadening of the market through more extensive involvement of the private sector" (129 Cong. Rec. S11780 (daily ed. Aug. 4, 1983)). The bill has two titles. Title I has been described as containing a number of securities amendments that would remove technical impediments to trading and investing in mortgage-related securities. Title II has been described as containing purely technical amendments to the Federal Home Loan Mortgage Corporation Act and the Federal National Mortgage Association Act. (129 Cong. Rec. S11783 (daily ed. Aug. 4, 1983)).

Section 101 of the bill would rewrite section 4(5) of the Securities Act of 1933, 15 U.S.C. § 77d(5). 15 U.S.C. § 77d is a listing of certain transactions which are exempted from the Securities Act registration requirements; subsection (5)(A) concerns promissory notes on real estate. Present law permits an exemption for promissory notes secured by a first lien on real estate upon which there is a residential or commercial structure and participation interests in these promissory notes (1) if the securities are originated by an institution examined by federal or state authorities and subject to the following conditions: (a) the minimum aggregate sales price per purchaser shall not be less than $250,000, (b) the purchaser shall pay cash at the time of the sale or within sixty days; and each purchaser shall buy only for his own account; or (2) if the securities are originated by a mortgagee approved by the Secretary of Housing and Urban Development according to certain specifications. Subsection (5)(B) exempts from registration requirements transactions between the entities described in (A)(i) or (A)(ii) involving non-assignable contracts to buy or sell securities which are to be completed within two years where the seller of the securities is one of the parties described in (A)(i) or (A)(ii) who may originate the securities and the purchaser of the securities is an institution described in (A)(i) or any insurance company described in (A)(ii), the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or the Government National Mortgage Association and where the securities are subject to the three conditions for sale set forth in (A)(i)(a) through (c). Subsection (5)(C) states that the exemption provided by (A) and (B) does not apply to resales of the securities unless each of the conditions for sale in (A)(i)(a) through (c) is satisfied.

The bill provides for exemption from registration requirements for transactions involving offers and sales of one or more promissory notes which are secured by a first lien or a second lien if the proceeds of the note were applied to the purchase of the security property or to improvements on it. The security property should be a single parcel of real estate upon which is located a residential or commercial structure or a residential manufactured home as defined in section 501(e) of the Depository Institutions Deregulation and Monetary Control Act of 1980. Further, participation interests in these notes or mortgage-related payment bonds secured by these notes or participation interests would be exempt from registration requirements. In addition to the above requirements, in order to be exempt from registration (1) the sales price for the note, participation interest, or mortgage-related payment bond must represent a denomination which, if sold on the initial sale date, would have been sold for at least $250,000 based upon the percentage of principal represented by the initial sales price, (2) the purchaser pays cash upon the earlier of the date of delivery of the note, participation interest, or mortgage-related payment bond or 120 days after the date upon which the purchaser committed to make the purchase, and (3) the notes were originated by an institution which is supervised and examined by a federal or state authority or were originated by a mortgage approved by the Secretary of Housing and Urban Development. A mortgage-related payment bond is defined as an obligation which provides for payments of principal in relation to payments on notes meeting the above requirements or participation interests which are pledged as security for the obligation and which are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

The present exemption contained in 15 U.S.C. § 77d(5) applies only to traditional first mortgages on real estate. However, the bill would also exempt securities backed by second mortgages, cooperative housing loans, and manufactured home loans. The bill, if enacted into law, would also change current law by permitting mortgage-backed securities to include mortgage-related payment bonds as well as notes directly secured by mortgages. In addition to financial institutions supervised and examined by federal or state authorities, the exemption from securities registration is made available by the bill to securities originated by any HUD-approved mortgagee. Current law requires the purchaser to pay cash for the security within sixty days of the sale; the bill provides for a cash payment requirement within 120 days of the sale. Finally, the requirement in current law that each purchaser shall buy only for his own account has been eliminated in the bill.

Section 102 of the bill would amend section 11(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78k(d), to insert "or securities described in section 4(5) of the Securities Act of 1933" after "exempted security" each place it appears. At present, 15 U.S.C. § 78k(d) makes it unlawful for a member of a national securities exchange who is a broker-dealer to effect through means of interstate commerce (1) any transaction in connection with which he arranges for credit which was part of a new issue in which he participated as a member of a selling group within thirty days before the transaction or (2) any transaction concerning a security other than an exempted security unless he discloses to the customer whether he is acting as a dealer for his own account or as a broker for the customer or for some other person. This amendment would make it possible for broker-dealers to extend credit to buyers of mortgage-related securities in the same way that they can extend credit for government agency securities.

Section 103 of the bill would amend section 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o, to add a statement that, in establishing credit reserve requirements for broker-dealers, the Securities and Exchange Commission shall give the same treatment to the mortgage-related securities exempted from the registration requirements of the 1933 Act (so long as these securities are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization) as the treatment given securities under section 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2). These securities under section 3(a)(2) are exempted from all registration requirements of the 1933 Act and consist essentially of obligations issued or guaranteed by the United States government or by state or local governments. Presently, section 15(c)(3) of the Securities Exchange Act of 1934 prohibits brokers and dealers from using any means of interstate commerce to affect a transaction which violates SEC rules concerning the financial responsibility of brokers and dealers. These SEC rules are statutorily required to govern the maintenance of reserves concerning customers' deposits or credit balances and to establish minimum financial responsibility requirements for all brokers and dealers. Section 103 of the bill would permit brokers and dealers to carry mortgage-related securities in their inventories without adversely affecting the net capital which the SEC requires them to carry. A dealer holding investment grade mortgage securities would be required to have only the same amount of capital as he is required to have for government securities.

Section 104 of the bill would amend section 4(c)(1) of the Home Owner's Loan Act of 1933, 12 U.S.C. § 1464(c)(1), which presently permits a federal savings and loan association to invest in or sell certain loans or investments without percentage of assets limitation, to include mortgage-backed securities.

Section 105 of the bill would amend 12 U.S.C. § 24 to provide that the restrictions in the seventh paragraph on national banking associations dealing in underwriting and purchasing investment securities for its own account shall not apply to mortgage-related securities. The statute now in force states that "the business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order,and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock."

Section 106(a) preempts state blue sky laws so that any person, trust, or organization existing under the laws of the United States or any state shall be permitted to purchase mortgage-related securities as though they were federal agency securities. Although a comprehensive fifty-state survey has not been done, it appears that many states have investor limitations on mortgage-related securities, because this type of security did not exist at the time that states passed investor limitation laws. Section 106(b) states that state blue sky laws are not preempted if a state enacts a provision within two years of the enactment of this federal statute finding that limitations on mortgage-related securities are necessary.

Section 107 would direct the Securities and Exchange Commission to extend the shelf registration rule for mortgage-related securities. The shelf registration rule, which can be found at 17 C.F.R. § 230.415 and is commonly referred to as Rule 415, presently states that until the end of 1983 securities may be registered for an offering to be made on a continuous or delayed basis provided that certain requirements are met. These requirements include the following: (1) The registration statement must pertain to certain kinds of securities, such as securities expected to be sold within two years from the effective date of the registration statement, securities which are to be sold by someone other than the registrant, securities which are to be sold pursuant to a dividend or interest reinvestment plan or an employee benefit plan of the registrant, or securities which are pledged as collateral. (2) The registrant must meet certain other registration requirements. For example, where voting stock is registered, the amount offered must not exceed 10% of the aggregate market value of the registrant's outstanding voting stock held by non-affiliates of the registrant; the securities must be sold through an underwriter acting as principal or as agent for the registrant; and the underwriter must be named in the prospectus.

Section 201 would amend section 306(f) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1455(f), to provide that preferred stock of the Corporation may have the rights that are permitted by the rules of the New York Stock Exchange for securities that are listed on it. Section 303 of the

National Housing Act, 12 U.S.C. § 1718, would have a similar provision added to it by section 202(b) of the bill. Section 202(a) of the bill would amend the first sentence of § 303(a) of the National Housing Act to provide that the national housing corporations shall have common stock vested with voting rights. These provisions appear to be technical in nature in that they would grant the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation the authority to issue preferred stock. Any issuance must comply with the New York Stock Exchange Rules concerning the rights of preferred shareholders.

Sections 203 and 204 would amend section 302(h) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451(h), which is the definition of "residential mortgage" for the Act. These provisions would amend this definition so that the Federal Home Loan Mortgage Corporation could purchase loans which are not used exclusively for home purchase or improvement and which are considered personal or mixed property instead of real property.

Section 205 would amend section 302(i) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451(i), which is the definition of "conventional mortgage," so that mortgages which are insured by a state agency would be included within the definition.

Section 206 would amend section 306 of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1455, to add a provision making it clear that the Federal Home Loan Mortgage Corporation cannot guarantee mortgage-backed securities other than those which it issues.

2. Background of 1933 and 1934 Securities Act

The basic purpose of the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.*, is to make certain that investors receive adequate and reliable information about securities that are offered to the public. In order to achieve this objective, the Act requires that securities offered to the public must be registered with the Securities and Exchange Commission and that potential investors be provided with certain information by the corporation before they decide whether to buy stock in that corporation. The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq*., is concerned with many different areas; one major concern is with the continuing regulation of publicly held companies. If a company meets certain shareholder and asset requirements, it must file periodic disclosure forms with the Commission.

Sanctions for violating either of these acts are generally phrased in terms of "fraud or deceit" or "manipulative or deceptive devices or contrivances." As for violations of the '33 Act, section 11, 15 U.S.C. § 77k, sets forth the civil liabilities to purchasers concerning any material misstatements or omissions by a corporation in its registration statement. Section 12(2) of the Act, 15 U.S.C. § 77(2), imposes liability on any person who offers or sells securities by a written or oral communication which misstates a material fact or omits a material fact necessary to make the statements made not misleading.

The antifraud provisions of the '34 Act are, for the most part, general in nature. Sections 9 and 10(a) of the '34 Act, 15 U.S.C. §§ 78i and 78j(a), concern prohibitions on a variety of manipulative activities. Section 10(b), 15 U.S.C. § 78j(b), contains a catch-all provision permitting the Securities and Exchange Commission to prohibit by rule any "manipulative or deceptive device or contrivance" concerning a security. The Commission has responded with Rule 10b-5;

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Since S.1821, 98th Congress, would add to the transactions exemptions of the '33 Act, the antifraud provisions of the Act likely would remain effective. Further, it would appear that the antifraud and disclosure requirements of the '34 Act would remain, thus preserving great a deal of investor protection.

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GLOSSARY OF SELECTED INVESTMENT TERMS

The definitions of terms which follow are verbatim extracts, mostly taken from The Language of Investing, Glossary (New York Stock Exchange, Inc., December 1981). Entries preceded by an asterisk (*) are from What Every Investor Should Know. A Handbook from the U.S. Securities and Exchange Commission (Office of Public Affairs, U.S. Securities and Exchange Commission, August 1982).

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Basis Point

One gradation on a 100-point scale representing one percent; used especially in expressing variations in the yields of bonds. Fixed income yields vary often and slightly within one percent and the basis point scale easily expresses these changes in hundredths of one percent. For example, the difference between 12.83% and 12.88% is 5 basis points.

Blue Sky Laws

A popular name for laws various states have enacted to protect the public against securities frauds. The term is believed to have originated when a judge ruled that a particular stock had about the same value as a patch of blue sky.

Broker

An agent, who handles the public's orders to buy and sell securities, commodities or other property. For this service a commission is charged.

*Corporate Bond

The most common form of corporate debt security is the bond, which is a certificate promising to repay, no later than a specified date, a sum of money which the investor, or bondholder, has loaned to the company. In return for the use of the money, the company also agrees to pay bondholders a certain amount of "interest," which is usually a percentage of the amount loaned. Since bondholders are not owners of the company, they do not share in dividend payments, or vote on company matters. The return of their investment is not usually dependent upon how successful the company is in business: bondholders are entitled to receive the amount of interest originally agreed upon, as well as a return of the principal amount of the bond, if they hold if for the time period specified. Most bonds issued by corporations are registered with the SEC.

Corporate bonds are issued in denominations of $1,000. This is the face value of the bond, and is the amount the company agrees to repay to the bondholder when the bond matures. Bonds may, however, trade at a discount--an amount less than their face value--or, at a premium--an amount greater than their face value--depending upon current market conditions, the movement of interest rates generally, and other factors.

Dealer.

An individual or firm in the securities business who buys and sells stocks and bonds as a principal rather than as an agent. The dealer's profit or loss is the difference between the price he pays and the price he receives for the same security. The dealer's confirmation must disclose to his customer that he has acted as principal. The same individual or firm may function, at different times, either as broker or dealer.

*Government Securities

The United States Government issues a variety of debt securities, including Treasury bills (commonly called T-bills), Treasury notes, and U.S. government agency bonds. T-bills are sold by the Treasury at auctions. Investors can buy all three types without incurring a commission directly from a Federal Reserve Bank or the Bureau of the Public Debt. Government securites can also be purchased from banks, government securities dealers, and other broker/dealers.

While government securities do not have to be registered with the SEC, transactions involving them must comply with the securities laws and the SEC's rules.

Hypothecation

The pledging of securities as collateral--for example, to secure the debt balance in a margin account.

Institutional Investor

An organization whose primary purpose is to invest its own assets or those held in trust by it for others. Includes pension funds, investment companies, insurance companies, universities and banks.

Interest

Payments a borrower pays a lender for the use of his nmoney. A corporation pays interest on its bonds to its bondholders.

Investment Banker

Also known as an underwriter. He is the middleman between the corporation issuing new securities and the public. The usual practice is for one or more investment bankers to buy outright from a corporation a new issue of stocks or bonds. The group forms a syndicate to sell the securities to individuals and institutions. Investment bankers also distribute very large blocks of stock or bonds--perhaps held by an estate.

Investment Company

A company or trust which uses its capital to invest in other companies. There are two principal types: the closed-end and the open-end, or mutual fund. Shares in closed-end investment companies, some of which are listed on the New York Stock Exchange, are readily transferable in the open market and are bought and sold like other shares. Capitalization of these companies remains the same unless action is taken to change, which is seldom. Open-end funds sell their own new shares to investors, stand ready to buy back their old shares, and are not listed. Open-end funds are so called because their capitalization is not fixed; they issue more shares as people want them.

Liquidity

The ability of the market in a particular security to absorb a reasonable amount of buying or selling at reasonable price changes. Liquidity is one of the most important characteristics of a good market.

*Margin Securities

Generally, there are two ways to finance securities purchases: through a cash account or through a margin account. With a cash account, the investor must pay the purchase price, in cash, no later than the settlement date (usually within five business days of the trade). In a margin account purchase the investor puts up part of the cost and the broker lends him the remaining amount. An investor opening a margin account signs a "margin agreement" similar to an agreement signed to obtain a bank loan. This document states the annual rate of interest, its method of computation, and specific conditions under which interest rates can be changed. Interest is usually computed daily on an annual percentage rate basis.

The Federal Reserve Board sets rules specifying the minimum percentage of the purchase price which a margin customer must pay in cash. Currently, the requirement is for at least 50 percent of the current market value of the security; that is, the broker may lend the customer no more than 50 percent of the value of the security. (Some securities may not be purchased on margin.) Buying on margin can provide investors with a means to increase "leverage" and therefore maximize profits. However, a decline in value of securities purchased on margin could cause severe losses to the investor. It is not unusual for an entire margin to be liquidated at a substantial loss because the securities in the account declined in value. Therefore, the investor must carefully and continually monitor the value of securities purchased on margin.

Mutual Fund

(See: Investment Company)

Over-The-Counter

A market for securities made up of securities dealers who may or may not be members of a securities exchange. The over-the-counter market is conducted over the telephone and deals mainly with stocks of companies without sufficient shares, stockholders, or earnings to warrant listing on an exchange. Over-the-counter dealers may act either as principals or as brokers for customers. The over-the-counter market is the principal market for bonds of all types.

Primary Distribution

Also called primary or public offering. The original sale of a company's securities.

Prospectus

The official selling circular that must be given to purchasers of new securities registered with the Securities and Exchange Commission. It highlights the much longer Registration Statement filed with the Commission. It warns that the issue has not been approved (or disapproved) by the Commission and discloses such material information as the issuer's property and business, the nature of the security offered, use of proceeds, issuer's competition and prospects, management's experience, history and remuneration and certified financial statements. A preliminary version of the prospectus, used by brokers to obtain buying indications from investors, is called a red herring. This is because of a front-page notice (printed in red ink) that the preliminary prospectus is "subject to completion or amendment" and "shall not constitute an offer to sell..."

*Ratings

Publicly held corporate bonds are rated by several private rating agencies. These agencies use a combination of letters A through D to estimate the risk for prospective investors. For example, AAA (or Aaa) is the highest quality bond while C or D rated bonds are in default of payment. The ratings are not meant to be a measure of the attractiveness of the bond as an investment, but rather how "safe" it is, if held to maturity.

Registered Bond

A bond which is registered on the books of the issuing company in the name of the owner. It can be transferred only when endorsed by the registered owner.

*Securities and Exchange Commission (SEC)

The Securities and Exchange Commission (SEC) is an independent agency of the United States Government which was established by Congress in 1934 to administer the Federal securities laws. It is headed by five Commissioners appointed by the President, who direct a staff composed of lawyers, accountants, financial analysts and other professionals. The staff operates from its headquarters in Washington, D.C., and from 15 field offices in major financial centers throughout the country.

The SEC's principal objectives are to make sure the securities markets operate in a fair and orderly manner; to see to it that securities industry professionals deal justly with their customers; and to assure that corporations make public all of the information about themselves that investors need in order to make intelligent investment decisions. The SEC pursues these objectives by overseeing the operations of the SROs [Self-Regulatory Organizations]; by adopting rules with which those involved in the purchase and sale of securities must comply; and by filing lawsuits or taking other enforcement action in cases where the law has been violated.

Despite the many protections provided by Federal and State securities laws, it is important for investors to remember that they have the ultimate responsibility for their own protection. In particular, the SEC cannot guarantee the worth of any security. That is a judgment each investor must make for himself.

Secondary Distribution

Also known as a secondary offering. The redistribution of a block of stock sometime after it has been sold by the issuing company. The sale is handled off the NYSE by a securities firm or group of firms and the shares are usually offered at a fixed price which is related to the current market price of the stock. Usually the block is a large one, such as might be involved in the settlement of an estate. The security may be listed or unlisted. (See Investment Banker, Primary Distribution.)

Street Name

Securities held in the name of a broker instead of his customer's name are said to be carried in "street name." This occurs when the securities have been bought on margin or when the customer wishes the security to be held by the broker.

Syndicate

A group of investment bankers who together underwrite and distribute a new issue of securities or a large block of an outstanding issue.

Yield

Also known as return. The dividends or interest paid by a company expressed as a percentage of the current price. A stock with a current market value of $40 a share paying dividends at the rate of $3.20 is said to return 8 percent ($3.20÷$40.00). The current yield on a bond is figured the same way. A 9 percent $1,000 bond selling at $600 offers a current yield of 15 percent ($90÷$600).

Yield To Maturity

The yield of a bond to maturity takes into account the price discount from or premium over the face amount. It is greater than the current yield when the bond is selling at a discount and less than the current yield when the bond is selling at a premium.

Zero Coupon Bonds

First issued by companies in 1981, they pay no interest but are priced at a discount of their redemption price. They offer the promise of reward through capital gains, which are normally taxed at a lower rate than income received as interest.

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PRIVATE MORTGAGE BACKED SECURITIES [1]

The basic financial instrument: PC

Existing mortgages are packaged into a mortgage pool, and investors purchase pass-through securities in the form of participation certificates (PCs) backed by this pool. Purchase of PCs gives investors an undivided interest in the mortgage pool. The underlying mortgages are administered by a loan servicer, an organization which collects individual mortgage monthly payments and loan prepayments and passes them through to pool participants as they are received. Losses not covered by the policies on individual mortgages are covered by a private mortgage insurance policy on the pool.

Privately issued (i.e., with no Government or government-related guarantee) mortgage securities as generally sold in the capital markets (i.e., publicly offered rather than privately placed) are distinguished by the type of guarantee provided with these securities. Financial institutions have packaged three types of PCs:

> *Bank or thrift institution PCs. A financial institution chooses mortgages from its portfolio for packaging in mortgage pool participation certificates. Private mortgage insurance companies provide the guarantees on the mortgages backing the PCs. These mortgage pools are usually concentrated in the region served by the lending institution which packages the mortgages, a factor which increases the exposure to the risk of natural disaster affecting the properties mortgaged. Typically, the PC issuer services the mortgages in the pool and passes through payments with a delay of fifty-five days; however, timely payment is not guaranteed by the PC issuer. These PCs are normally rated AA by Standard & Poor's Corporation, that is, one notch below the most highly rated financial instruments.

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[1] Descriptive material drawn primarily from August, Kathy and John Holmgren, Mortgage Backed Securities; in Blume, Marshall E. and Jack P. Friedman (eds.), Encyclopedia of Investments. Boston, Warren, Gorham & Lamont, 1982. p. 441-462.

The first publicly offered direct PC issue, for $150 million, was made by the Bank of America in 1977. The administrative costs associated with a publicly offered PC are such that a minimum size of $25 million per issue is indicated; these direct PCs are usually purchased in increments of $5,000 with a $25,000 minimum.

*Conduit Firm PCs. Lending institutions unable to issue their own PCs may look to a conduit firm which purchases mortgages from a variety of sources, packages them into mortgage pools, and acts as master servicer for the PC issue. Conduit firms may arrange their loan purchases so that the mortgage pool which is put together is not restricted to one geographical area; in addition, the conduit firm requires the seller of the loan (i.e., the original mortgage lender) to retain a service fee large enough to insure that servicing the mortgages is attractive. In other respects, conduit firm PCs are similar to bank or thrift institution PCs, including a Standard & Poor's AA rating.

PMI Mortgage Corporation issued the first publicly offered private conduit PC in 1979; this PC issue was for $27 million.

*Subordinated position PCs. In this variation of a bank or thrift institution PC, the mortgage pool guarantee is provided by the issuing institution rather than by private mortgage insurance. This method may lower administrative costs, and can result in a AAA Standard & Poor's rating.

Characteristics of Lending Institution PCs.

1) Risk. Mortgage backed securities are similar to corporate fixed income securities (i.e., bonds and notes) in that the primary risk for an investor is the possibility that principal and interest will not be forthcoming in a timely fashion. Because mortgage backed securities are fully collateralized, an element of risk reduction is provided by the nature of the mortgages in the PC pool. Before a loan is made, both the homeowner-borrower and the property are investigated so that a mortgage loan represents the result of a thorough initial screening process designed to minimize the possibility of default. The issuer guarantees the pool participant against any loss due to a default on mortgage loans in the pool, backed by private mortgage insurance.

Once issued, the price of mortgage backed securities will move in an inverse relationship to market interest rates, a characteristic shared with all debt securities and a risk generally understood by experienced investors.

2) Cash Flow. The payment stream to pool participants includes interest on the mortgage loans, monthly mortgage payments on the principal of the loans, loan prepayments, and prepayment penalties. The issuer may intend to make timely payments, but does not guarantee them. For these reasons, monthly payments to PC holders tend to be erratic and, to a degree determined by prepayments, unpredictable.

3) Liquidity. Converting a security to cash without delay and without discounting would be perfect liquidity, a condition most closely approximated by securities with a large volume of outstanding positions which are actively traded in a resale or secondary market. Liquidity can be enhanced if trading possibilities exist in forward, future, or options markets. Private mortgage backed securities are currently relatively illiquid, lacking a large volume and active trading.

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SHELF REGISTRATION OF CORPORATE SECURITIES: THE SECURITIES AND EXCHANGE COMMISSION'S RULE 415

INTRODUCTION

In June 1981, the American Telephone and Telegraph Company (AT&T) sold 18.1 million shares of stock valued at $1 billion. The sale took place in a conventional manner: a syndicate of 255 investment banks bought the stock from the corporation and resold it to the public through a selling group of brokers and dealers. The stock was sold over a nine-day period, and 40 percent of the shares went to individual investors (see the appendix for a schematic rendering of this process). AT&T's next issue of stock, in May 1982, was purchased by a single investment bank, which resold the 2 million shares within a few hours, almost entirely to institutional investors. The striking differences between the two deals are largely attributable to a Securities and Exchange Commission (SEC) administrative ruling, Rule 415, which may bring significant changes in the way corporate securities are sold to the public.

RULE 415

The SEC's Rule 415, which took effect in March 1982, and is now in force on a temporary basis until December 31, 1983, permits shelf registration of corporate securities. Under this rule, a corporation may file a single registration statement with the SEC, covering all the securities of one class it expects to issue within two years, and then sell the securities "off the shelf" at any time during that period without further disclosure. Any subsequent developments in the corporation's financial condition which would reflect a fundamental change in the information set forth in the registration statement" require the filing of a post-effective amendment to the registration. In the past, under the Securities Act of 1933, each public offering of securities required a voluminous registration statement disclosing detailed information on the corporation's finances and management, including a prospectus to be circulated among potential investors. No sale of securities could take place until the SEC approved the registration, which often took over a month. Once the shelf registration is approved, by contrast, the time from the decision to offer stocks or bonds to the actual sale to investors need be no more than a few hours.

Shelf registration has been used extensively since taking effect. During the twelve months from March 1982 to February 1983, 284 shelf registrations were filed for $65.2 billion in debt offerings. $19.9 billion in debt was actually issued, which equalled 40 percent of all debt issued during that year. There were 69 shelf registrations for equity issues, and 64 actual offerings, valued at $3.2 billion, or 12 percent of the total during the year. 1/ Rule 415 also covers "traditional" shelf filings, such as employee stock ownership plans, dividend reinvestment plans, tax shelters, and mortgage participation offerings. Public interest and controversy have focused on offerings of corporate securities, however. The principal arguments for and against shelf registration are summarized below.

ARGUMENTS IN FAVOR

Supporters of Rule 415 include many of the corporations using it and the Justice Department. They generally view the rule as a timely simplification

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1/ Bureau of National Affairs. Securities Regulation and Law Report, v. 15, May 6, 1983. p. 886.

of cumbersome and duplicative regulatory requirements. Corporations whose securities are publicly held and traded are required to file periodic reports with the SEC under the Securities Exchange Act of 1934, and it is argued that these disclosures, as well as the constant scrutiny of stock analysts and bond rating firms, ensure that sufficient information will be available to investors. Some believe that the composition of new registration documents each time a corporation offers securities to the market is superfluous; an often-voiced, if rather cynical, opinion in the securities business is that prospectuses go largely unread by purchasers of securities.

Corporations also appreciate the speed with which they can bring securities to market under shelf registration. They are able to take advantage of brief "windows" of favorable market conditions, a valuable capability given the volatile markets of recent years.

Rule 415 was also expected to lower the costs of raising capital. The shelf registration statement need not specify a lead underwriter, but may list several, any of whom may then manage a particular offering. Many observers expect this system to encourage competitive bidding among underwriters, to the issuer's benefit. However, one survey of deals made before and after Rule 415 took effect did not find any trend toward lower spreads, or compensation of underwriters. 2/

ARGUMENTS AGAINST

Opposition to Rule 415 has come mainly from the securities industry, in particular from smaller and regional investment bankers. There are two general objections to Rule 415: that it undermines a traditional protection of

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2/ McGoldrick, Beth. Life with Rule 415. Institutional Investor, v. 17, February 1983. p. 132-3.

investors, and that its effect on capital markets is potentially disruptive.

Section 11 of the Securities Act of 1933 requires that underwriters exercise "due diligence" to ensure that there are no omissions or inaccuracies of fact in the prospectus or registration statement accompanying a securities offering. Traditionally, investigation of the issuing firm's financial condition has been a key function of the investment banker. Opponents of Rule 415 argue that the speed at which shelf-registered securities are sold makes any substantial evaluation impossible. The chairman of a leading investment banking house has suggested that Penn Central could have issued securities right up to its collapse had shelf registration been available at that time. 3/

Critics also fear that shelf registration could have damaging effects on the securities industry. Under the shelf registration rule, the use of broad-based syndicates of investment bankers to underwrite and distribute large securities offerings is expected to decline. Participation in such syndicates, which may include hundreds of firms, has long been an important source of income for regional investment banks, as well as their only access to primary distributions of securities of the largest corporations. The Securities Industry Association has expressed concern that a weakening of regional investment bankers could hamper the capital-raising efforts of small businesses and developing industries. 4/

The prospect of large securities offerings being underwritten by one or a few investment banks has raised other concerns. An investment bank with a sizeable portion of its capital at risk in a particular issue will try to

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3/ Gutfreund, John H. The SEC's Rule 415. Trusts and Estates, v. 121, August 1982. p. 12.

4/ Securities Group Seeks Delay of SEC Rule Easing Requirements for Stock Offerings. Wall Street Journal, March 16, 1982. p. 10.

sell the issue very quickly--primarily to institutional investors. Some fear the eventual result will be a loss of liquidity in the secondary or resale markets. Also foreseen is a trend toward increased concentration in investment banking, which could neutralize any advantage gained from increased competition among underwriters.

Another possibility, which some commentators view as a threat to the long-term stability of capital markets, is that corporations may sell securities "off the shelf" directly to institutional buyers, cutting out the investment banker altogether. The increased flexibility with regard to type and size of securities offerings may make deals of this kind more common.

Various modifications to Rule 415 have been proposed. Several commentators have called for a "cooling off" period between the announcement and the actual sale of securities. The intention is to give investors more time to evaluate the issue and the issuers. Others, including SEC Commissioner Barbara S. Thomas, propose that shelf registration be limited to debt securities, since bond rating firms rate each issue of debt, and no comparable rating exists for equities. Another proposed amendment would limit use of shelf registration to corporations eligible to use the SEC's S-3 registration form. Form S-3 is available only to corporations with over $150 million in voting stock in public hands or with an annual trading volume of over three million shares. These corporations are widely followed by securities analysts, and information about them is thought to be readily available in the marketplace.

Because shelf registration has proven so controversial, the SEC has not yet decided to adopt Rule 415 on a permanent basis. It has held hearings and asked for comments several times; a final decision on whether to extend, modify, or drop the rule is expected in the fall of 1983.

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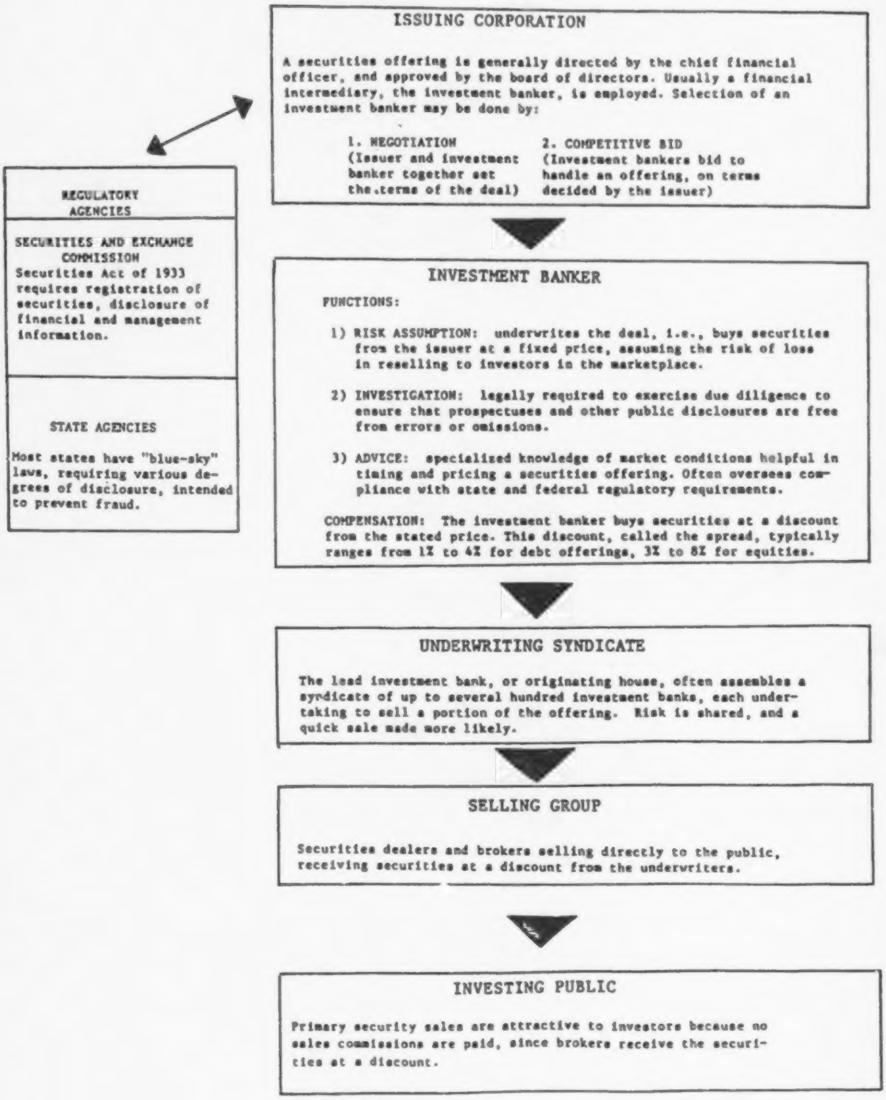
September 13, 1983

APPENDIX. BRINGING CORPORATE SECURITIES TO THE PUBLIC



ISSUING CORPORATION

A securities offering is generally directed by the chief financial officer, and approved by the board of directors. Usually a financial intermediary, the investment banker, is employed. Selection of an investment banker may be done by:

1. NEGOTIATION (Issuer and investment banker together set the terms of the deal)
2. COMPETITIVE BID (Investment bankers bid to handle an offering, on terms decided by the issuer)

REGULATORY AGENCIES

SECURITIES AND EXCHANGE COMMISSION
Securities Act of 1933 requires registration of securities, disclosure of financial and management information.

STATE AGENCIES

Most states have "blue-sky" laws, requiring various degrees of disclosure, intended to prevent fraud.

INVESTMENT BANKER

FUNCTIONS:

1) RISK ASSUMPTION: underwrites the deal, i.e., buys securities from the issuer at a fixed price, assuming the risk of loss in reselling to investors in the marketplace.

2) INVESTIGATION: legally required to exercise due diligence to ensure that prospectuses and other public disclosures are free from errors or omissions.

3) ADVICE: specialized knowledge of market conditions helpful in timing and pricing a securities offering. Often oversees compliance with state and federal regulatory requirements.

COMPENSATION: The investment banker buys securities at a discount from the stated price. This discount, called the spread, typically ranges from 1% to 4% for debt offerings, 3% to 8% for equities.

UNDERWRITING SYNDICATE

The lead investment bank, or originating house, often assembles a syndicate of up to several hundred investment banks, each undertaking to sell a portion of the offering. Risk is shared, and a quick sale made more likely.

SELLING GROUP

Securities dealers and brokers selling directly to the public, receiving securities at a discount from the underwriters.

INVESTING PUBLIC

Primary security sales are attractive to investors because no sales commissions are paid, since brokers receive the securities at a discount.

Source: Chart prepared by CRS.

STATE SECURITIES REGULATION: BLUE SKY LAWS AND THE PROPOSED EXEMPTION (S. 1821, 98th CONGRESS) OF PRIVATE MORTGAGE BACKED SECURITIES

BACKGROUND

Following repeated instances of fraud associated with the sale of corporate securities, State legislatures early in the century passed laws to supervise and regulate securities offered to their citizens. The first such law was passed by Kansas in 1911 and served as a model for many other States; the popular label stems from the intention "to check stock swindlers so barefaced they 'would sell building lots in the blue sky.'" 1/ By 1933, every State but one had enacted a blue sky law, but a variety of factors including exemption of classes of securities, lax enforcement, and legislative loopholes combined to insure that the curtailment of securities fraud would be less than perfect.

> Rarely have statutes enacted with such fanfare and general support subsequently been so universally deprecated. In the brutal glare that followed the stock market crash, it was apparent to virtually all commentators and congressional witnesses on the subject that the blue sky laws never really had a chance to succeed. As early as 1915, the Investment Bankers Association had reported to its members that they could "ignore" all blue sky laws by making offerings across state lines through the mails. Unscrupulous securities promoters soon adopted the technique. A 1933 Department of Commerce study found, "The most effective and widely used method of evading the provision of State blue sky laws consists in operating across State lines." Robert E. Healy, chief counsel to the Federal Trade Commission, testified before Congress that same year that over 90 percent of the securities sold in Pennsylvania were sold through the mails. 2/

1/ Seligman, Joel. The Transformation of Wall Street. Boston, Houghton, Miflin, 1982. p. 44.

2/ Ibid., p. 45. Footnote in original omitted.

Federal legislation--the Securities Act of 1933 and the Securities Exchange Act of 1934--was intended in part to supplement State blue sky laws to make them more effective. Section 18 of the 1933 Act specifically left intact State jurisdiction of securities.

STATE AND FEDERAL SECURITIES REGULATION

The North American Securities Administrators Association (NASAA) frequently speaks for State securities regulators as a group. The keystone of securities regulation is generally the requirement for registration, and in the case of the State, registration is effectively a license to sell securities. NASAA prepared the following comparison of State and Federal securities registration.

> Registration of securities, broker-dealers and agents is required under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as most state Blue Sky Laws. However, the manner in which securities offerings are reviewed and evaluated differs markedly under Federal and State regulating schemes. Federal law requires the issuer to give the investing public complete and truthful information about the securities being offered. If that is done, the securities are entitled to be registered no matter how speculative they may be. The Blue Sky Laws requiring securities registration function, in most instances, as licensing laws. Full disclosure does not automatically result in registration. It is up to the Blue Sky Administrators to decide whether and under what conditions the securities should be sold in their respective State. The public policy reasons for making these determinations must be left to the individual states who are in the best position to ascertain the needs of their citizens. It would be most unwise to adversely impact upon the role of the states in securities regulation unless the Federal government is prepared to commit enormous additional resources to policing problems of fraud.
>
> Many Blue Sky Laws establish substantive merit standards of fairness which are applied to securities offerings. The Registration of an offering may be denied on the basis that it would be "unfair, unjust or inequitable" or tend to work a fraud on the purchasing constituents of that State. The strength of the American securities markets lies in these merit standards which are applied in such investor-rich states as California, Texas and Illinois, and are mirrored in Federal Registration. The structuring of offerings and prospectuses to meet those standards in those important states constitutes the minimal level of acceptability for national offerings.

> Through NASAA, the State Securities Administrators are able to combine regulatory expertise, receive input from industry and achieve a significant degree of uniformity and cooperation in the administration of State securities laws. Guidelines for the structure of public offerings in oil and gas, real estate, stock options and warrants have been formulated by NASAA in this manner and are recognized today as standards in the market place. 3/

As a negative example, NASAA frequently refers to the Commodity Futures Trading Act of 1974 which gave the Commodity Futures Trading Commission (CFTC) exclusive jurisdiction over exchange-traded commodity futures contracts; the Federal authority created included preemption of general anti-fraud provisions of State law. NASAA has been highly critical of the CFTC's performance and lobbied strongly for a return of some State authority in 1978 and 1982 congressional hearings concerned with CFTC reauthorization. 4/

BLUE SKY EXEMPTION FOR PRIVATE MORTGAGE BAKED SECURITIES

State securities laws are intended to protect the investing public from fraudulent schemes in securities sales. Private mortgage backed securities are marketed primarily to large institutional investors, and it might be reasonable to expect that these potential investors are sufficiently sophisticated, and have developed adequate internal expertise in evaluating prospective securities purchases that they are less vulnerable to persuasive sales techniques promoting securities of questionable value.

3/ U.S. Congress. House. Committee on Energy and Commerce. Subcommittee on Telecommunications, Consumer Protection, and Finance. The Securities Industry: Economic Implications for the Future. Hearings, 97th Cong., 1st sess., June 17 and 18, 1981. Washington, U.S. Govt. Print. Off., 1981. Statement of Thomas L. Krebs, President of the North American Securities Administrators Association, Inc. p. 240-241.

4/ See: U.S. Library of Congress. Congressional Research Service. Issues in the Regulation of Futures and Options Trading [by] Julius W. Allen. Washington, 1983. (Report No. 83-108E) p. 47-49.

It has also been suggested that as the law now stands, issuers of private mortgage backed securities are placed in a disadvantageous position. The following material is extracted from material prepared in 1982 by a private law firm for the President's Commission on Housing.

> Most state securities laws exempt from registration requirements securities which are senior to or of substantially equal rank with securities of the same issuer which are listed or approved for listing on the New York Stock Exchange, the American Stock Exchange, or a specified regional exchange.
>
> The state securities regulators which have considered the question have taken the view that this exemption is not available to an issuer of mortgage pass-through securities because the issuer is not the obligor on the securities. Hence, if a company has common stock listed on the New York Stock Exchange, it may issue corporate bonds (even subordinated debentures) without registration under the typical State blue sky law, but if the company issues mortgage pass-through securities it must register them. This is unfair because, in most cases, the pass-through securities have an investment quality equal to or higher than the issuer's own debt securities. It is also expensive and time consuming. Typical filing fees for a $100,000,000 issue of mortgage pass-through certificates range from $30,000 to $40,000. Also, since a minimum of three weeks for processing must be allowed, mortgage pass-through certificates cannot be marketed quickly in reaction to a "window" in the market. This delayed reaction time is a major disadvantage in today's volatile interest rate environment.

5/ Brown, Wood, Ivey, Mitchell & Petty. Letter dated February 4, 1982. p. 28-30.

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NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION
STATEMENT OF POSITION ON S. 1821

The North American Securities Administrators Association, Inc. (NASAA) appreciates the opportunity to comment on Section 106 of S. 1821 which may preempt State Blue Sky and legal investment laws and regulations. NASAA is the organization which represents state securities officials charged with administering and enforcing their jurisdiction's securities laws and regulations.

According to Senator Tower, S. 1821 is designed to encourage a broadening of the secondary mortgage market. This legislation is intended to remove regulatory impediments which prevent mortgage pass-through securities from trading at least as well as other corporate securities (emphasis added).

State securities laws currently provide exemptions from the registration provisions of such laws via numerous transactional exemptions. One such exemption, the so-called "institutional investor exemption," pertains to the purchase of securities by regulated financial institutions. This exemption is included in Section 402 (b)(8) of the Uniform Securities Act.

In considering the bill, it is highly significant to realize that the Securities Act of 1933 does not contain a similar institutional investor exemption. To achieve a parallel exemption on the federal level, it is therefore necessary to amend numerous sections of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Given the existence of the institutional investor exemption in the Uniform Securities Act, this bill's goal can be achieved in the states without preempting state securities laws. Therefore, NASAA recommends that a new paragraph (c) be added to Section 106. The language to be included in new paragraph (c) should be,

> "Nothing in this Act shall preempt the application of state securities laws."

STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION SUBMITTED TO THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE, ON S. 1821

September 27, 1983

The Securities and Exchange Commission appreciates this opportunity to respond to Chairman Tower's request for recommendations to improve S. 1821.

The objective of S. 1821 -- enhancing the private secondary market in mortgage-related securities -- is a goal that the Commission shares. For some time, the Commission and its staff have been working with private issuers of mortgage-related securities to streamline securities registration procedures and to reduce unnecessary regulatory burdens.

S. 1821 and its companion bill, S. 1822, offer an excellent opportunity to encourage development of the private secondary mortgage market in the United States. The Commission is pleased to be able to assist the Subcommittee in taking advantage of this opportunity. We therefore offer the following specific comments on the bill.

Section 101 -- Registration Exemption

Section 101 of S. 1821 would enlarge the exemption for mortgage-related securities provided by Section 4(5) of the Securities Act of 1933 (the "1933 Act") in the following manner:

1. Expand the securities covered by the exemption. Currently, the exemption covers transactions in first mortgages on real estate and participation

interests in such mortgages. S. 1821 would extend the coverage of the exemption to transactions in (a) second mortgages on real estate, (b) loans on cooperative housing units, (c) loans on manufactured homes, (d) participation interests in the preceding items, and (e) mortgage-related payment bonds (*i.e.*, investment grade bonds secured by mortgages or participation interests of the kind covered by the exemption).

2. *Liberalize the restrictions on sale transactions.* The bill purports to "clarify" the current minimum transaction amount of $250,000 so that it would apply only to the "initial purchase amount." It would also extend the period for paying this amount in cash from 60 to 120 days (computed from the date of delivery, rather than the date of sale), and eliminate the provision prohibiting the purchaser from buying for the accounts of others.

3. *Broaden the types of originating institutions.* Under the bill, credit unions and insurance companies supervised and examined by a federal or state authority, as well as mortgagees approved by HUD, would be added to the list of institutions that may originate mortgage-related securities without registration. The exemption is available now for mortgage-related securities originated by savings and loan associations, savings banks, commercial banks, similar banking institutions supervised and examined by a federal or state authority, and mortgagees approved by HUD who sell only to the foregoing entities.

In addition, the bill would delete existing Subparagraphs (B) and (C) of Section 4(5). Subparagraph (B) provides an exemption for transactions involving contracts between institutions to buy or sell within two years the securities referred to in the exemption. Subparagraph (C) states that the restrictions applicable to initial sales (*i.e.*, purchase of $250,000 minimum for one's own account to be paid within 60 days) applies to resales under the Section.

The Commission supports an expansion of Section 4(5) to the extent that it is consistent with the considerations that led the Commission to support Section 4(5) in 1975, when the provision was enacted originally. At the time, the Commission believed that the Section 4(5) exemption would promote a strong secondary mortgage market without harming the general investing public because it was structured in such a way that it would not be available for sales to the general public. The premise underlying the exemption was that institutional and similar purchasers who could meet the conditions for buying securities under it do not need the protections afforded by the registration process. The general public, on the other hand, needs such protections, and the Commission believed then, as it does now, that the exemption should not be available for transactions involving the general public.

To the extent that registration is necessary for distributions of mortgage-related securities to the general public, there exists a registration procedure that facilitates the distribution process. Under the Commission's Rule 415, an issuer can register in one filing all of the mortgage-related securities it expects to sell over the next two years and then take those securities "off the shelf" and sell them whenever it chooses during the two-year period. Thus, the rule allows the issuer to sell at the most advantageous time. Moreover, the registration process allows the issuer to sell freely-tradable securities, an advantage that does not exist for sellers under the Section 4(5) exemption.

On the basis of the above considerations, the Commission supports S. 1821 to the extent that the bill seeks to broaden the scope of the Section 4(5) exemption by expanding the types of securities covered by it (Item 1 above) and increasing the number of regulated institutions that may originate mortgage-related securities under it (Item 3). These changes would promote a strong secondary mortgage market and, so long as the unregistered portion of that market is confined to institutional and similar purchasers, no harm to the general investing public would result. Similarly, the deletion of Subparagraphs (B) and (C) would not harm investors, since the absence of (B) would simply reduce the scope of the exemption and (C) is nothing more than surplusage, added out of an excess of caution to assure that resales were not made to the general public.

The provisions of Section 101 that would ease restrictions on sale transactions (Item 2 above) raise different issues. These provisions would permit a sale price of less than $250,000 in some transactions and allow purchasers to buy for the accounts of others and to settle their cash payment obligation in 120 days rather than 60 days. They would greatly enhance the likelihood that the exemption would be used for sales of mortgage-related securities to the general public without requiring appropriate disclosures.

The provisions that would ease sale restrictions would permit brokers and others to pool assets of numerous small investors to meet the minimum purchase requirement. Moreover, the additional 60 days allowed for meeting the cash payment requirement could serve to provide extra time to arrange outside financing for purchases by small investors. This, of course, would be contrary to the original purpose of Section 4(5) to exclude sales to small investors from its coverage.

The Commission would not object to a 120-day settlement period as long as the minimum purchase price of $250,000 and the requirement that a purchaser buy only for his own account are retained. These requirements are essential to maintaining Section 4(5) as an exemption available for sales to institutional and similar investors only and not for sales to the general public. The attached revised draft of Section 4(5) attempts to balance appropriately the objective of S. 1821 to promote a strong secondary mortgage market with the protection of small investors.

In its present form, the provision permitting a sale price of less than $250,000 may also open the door to use of Section 4(5) for sales to small investors. The language of the provision states that a security is covered by Section 4(5) if it represents

> a participation interest or denomination which, if sold on the initial sale date, would have been sold for at least $250,000 based on the percentage of principal represented by the initial sales price.

This language would exempt a sale for $1,000 of a security originally backed by some mortgages that have been paid off or by mortgages the principal of which has been significantly paid down. Moreover, the provision uses terms such as "initial sale date" and "initial sales price" which are undefined and capable of varying interpretations.

It appears that this provision was included to allay concerns that, under existing law, the $250,000 minimum requirement can be satisfied only if the outstanding principal on the security is at least $250,000 at the time of sale. This is not the Commission's reading of the current Section 4(5). Interpretive problems of this sort are usually resolved administratively. The Commission has taken no steps to deal with this one because it has been unaware that significant problems have arisen in this area. If they have, it may be preferable to address them in the legislative history of S. 1821 or to clarify the language of Section 101 so that it does not permit sales under Section 4(5) to small investors.

The language of Section 101 is subject to two interpretations as to whether revised Section 4(5) would exempt participation interests in mortgage-related payment bonds from the registration provisions of the 1933 Act. The amendment would exempt "participation interests in [certain promissory] notes or mortgage-related payment bonds secured by such notes or participation interests." The question is whether the words "participation interests in" apply only to the promissory notes or also to the words following the word "or," i.e., "mortgage related payment bonds secured by such notes or participation interests." The better interpretation is that the words "participation interests in" apply only to the promissory notes, and that, therefore, participation interests in mortgage-related payment bonds would not be covered by the revised Section 4(5) exemption. It is assumed that this is the correct interpretation in the discussion above. The attached revised draft of Section 4(5) also follows this interpretation. If the version of Section 4(5) in S. 1821 is retained, however, the intent of the bill in this regard should be clarified.

If it is intended that Section 4(5) cover participation interests in mortgage-related payment bonds, the Subcommittee should recognize that the issuer of these securities may be an investment company required to register under the Investment Company Act of 1940 (the "1940 Act"). Mortgage-related payment bonds would be "securities" within the meaning of the 1940 Act. An issuer primarily engaged in investing in them could be an investment company unless by reason of special circumstances the securities are regarded as "mortgages and other liens on and interests in real estate." */

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*/ For example, the Commission's staff has taken the position that an entity that invests in all of the GNMA certificates issued with respect to a pool of mortgages, and which intends to hold all of the certificates, would be regarded as investing in the underlying mortgages.

We note further that the language of the Section-by-Section Analysis indicates that Section 101 would extend the limit for cash payment on Section 4(5) securities from 60 to 120 days, while the bill would require payment on the earlier of the delivery of the security or 120 days after the commitment date. We have assumed that the former was intended.

The Commission supports S. 1821's use of the concept "investment grade securities." The bill uses the concept to refer to mortgage-related securities which "are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization." This definition is essentially the same as that used in the Commission's integrated disclosure system to determine when an issuer may use a short-form prospectus to register nonconvertible debt and preferred stock. Form S-3 may be used to register such securities if they are "investment grade securities," defined as securities which at least one nationally recognized statistical rating organization has rated in one of its generic rating categories signifying investment grade. Form S-3 goes on to specify that, typically, the four highest rating categories signify investment grade. This same concept is used in Rule 10b-6 under the 1934 Act to exempt issuers from the trading prohibitions of that Rule. */

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*/ In a similar vein, the Commission's net capital rule treats nonconvertible debt securities more favorably if they are rated in one of the four highest rating categories by two nationally recognized statistical rating organizations.

This treatment of investment grade debt and preferred stock is based on the belief that such securities generally trade in accordance with a concept of relative value, i.e., such securities are to a large degree fungible. Investors purchase these securities on the basis of interest rates, maturities, and security ratings. Thus, extremely detailed prospectuses are not needed to register these securities.

There are now five nationally recognized rating organizations: (1) Moody's Investors Service, Inc; (2) Standard & Poor's Corp.; (3) Fitch Investors Service, Inc.; (4) Duff & Phelps, Inc.; and (5) McCarthy, Crisanti & Maffei. The Commission has experienced no problems in applying the investment grade securities concept. Accordingly, we support S. 1821's use of this concept in relation to mortgage-related securities.

Section 102 -- Extensions of Credit

Section 102 of S. 1821 would amend Section 11(d)(1) of the Securities Exchange Act of 1934 (the "1934 Act") to permit broker-dealers to extend credit in connection with the initial sale of securities exempt from registration under revised Section 4(5) of the 1933 Act. Section 11(d)(1) prohibits a broker-dealer from extending credit to purchase any security (other than an exempted security) that was part of a new issue in the distribution of which the broker-dealer participated in the last 30 days. The Section was designed to prevent overreaching by a person acting as both broker and dealer by preventing him from inducing his customers to buy on credit securities that he has undertaken to distribute to the public.

Section 102 appears to be inconsistent with Section 101. Section 101 effectively prohibits extending credit to purchase securities exempt from registration under revised Section 4(5) by requiring that the purchaser pay cash upon the earlier of (1) the date of delivery of the security or (2) 120 days after the date of the commitment to purchase the security. Thus, even if Section 102 were adopted, a broker-dealer could not extend credit on mortgage-related securities exempt under Section 4(5). Deleting Section 102 would eliminate confusion as to the meaning of the cash payment provisions of revised Section 4(5).

It appears from the Section-by-Section Analysis that Section 102 may have been intended to permit broker-dealers to extend credit on the initial sale in a registered offering of securities that are marginable under Regulation T, adopted by the Board of Governors of the Federal Reserve System under Section 7 of the Securities Exchange Act. If that is the case, we would be glad to discuss such an amendment with the Subcommittee. We note, however, that exempting mortgage securities marginable under Regulation T from Section 11(d)(1) would create a disparity between those securities and all corporate securities, which are subject to the prohibitions of Section 11(d)(1). The policies underlying the bill may justify such a disparity, but we urge that Congress be satisfied that the existing rules do, in fact, impose substantial burdens on this market before singling out mortgage-related securities for this special treatment.

Section 103 -- Net Capital Rule

Section 103 of S. 1821 would effectively require the Commission, in applying its net capital rule, to accord the same treatment to highly-rated mortgage-related securities exempt under revised Section 4(5) as the treatment accorded exempt securities as defined in Section 3(a)(2) of the 1933 Act.

The Commission has developed its net capital rule under Section 15(c)(3) of the 1934 Act. The rule is designed to ensure that broker-dealers maintain adequate financial liquidity in the event of market fluctuations. In computing net capital, a broker-dealer must deduct from its net worth a prescribed percentage of the value of securities it owns (a "haircut"). The haircut is based on detailed analyses of market fluctuations over a period of years. The net capital rule currently provides separate haircut schedules for United States government securities ("government securities"), short-term market instruments, municipal securities, nonconvertible debt securities, and convertible debt securities.

The Commission has no reason to believe that the current treatment of mortgage-related securities under the net capital rule has any substantial inhibiting effect on the development of the market for them. Without evidence that the net capital rule is a problem, the Commission would be reluctant to support special treatment for mortgage-related securities. Specifying by statute the net capital position to be afforded mortgage-related securities may unduly limit the Commission's authority to establish financial responsibility standards. The appropriate haircut for particular securities is subject to change dependent on market conditions. The liquidity of the market and price fluctuations in non-government mortgage securities are not the same as those for government securities. Accordingly, treating non-government mortgage securities the same as government mortgage securities, the objective of Section 103, is not appropriate.

We also note that the language of Section 103 is ambiguous. The description of Section 103 in the Section-by-Section Analysis of S. 1821 states that "investment grade" mortgage securities held in a dealer's inventory would only require the same amount of capital as government securities of comparable maturity. The actual language of Section 103, however, refers to Section 3(a)(2) of the 1933 Act, which relates not only to government securities but also to municipal securities and other securities. We assume that Section 103 is intended to refer to government securities of comparable maturity. If the provision is retained, it should be redrafted to make that clear.

Section 105 -- Glass-Steagall Amendment

Section 105 of S. 1821 would amend the Glass-Steagall Act to allow national banks and state-chartered member banks to deal in and underwrite mortgage-related securities exempt under Section 4(5) of the 1933 Act. The Commission has taken the position, however, that banks that expand their securities activities should conduct all securities activities through separate corporate affiliates that are subject to the same regulations and tax treatment as other securities firms. The Department of the Treasury has recommended legislation (S. 1609) which would implement that concept and make other important changes in banking regulation. Among other things, that bill would amend the Glass-Steagall Act to authorize bank affiliates to underwrite municipal revenue bonds and mutual fund shares. The Commission recommends that Section 105 of S. 1821 be deleted and that the question of whether banks or bank affiliates should be permitted to deal in and underwrite mortgage-related securities be considered in conjunction with S. 1609.

Section 107 -- Shelf Registration

The Commission favors shelf registration of mortgage-related securities, as Section 107 of S. 1821 would provide.

Indeed, the Commission had allowed shelf registration of such securities on an administrative basis before the adoption of its Rule 415, which allows shelf registration generally. Rule 415 was adopted on a temporary basis in March 1982. It is effective until December 31, 1983. The Commission is scheduled to consider its experience under Rule 415 and make a final determination as to the future of the Rule in November 1983.

Shelf registration is essential to the objectives of S. 1821. It is one of two critical elements that facilitate capital formation in the context of mortgage-related securities. Together with the other element, formation of blind pools, shelf registration allows capital to be raised through the public sale of registered mortgage-related securities in an efficient and economical manner. Issuers can match capital demands with portfolio holdings; that is, they can form pools of mortgages as sales of securities backed by those mortgages take place. It is not necessary for the mortgages to be purchased before the securities are registered, priced, and sold. With an effective shelf registration statement, pricing and sales can occur contemporaneously with mortgage acquisition.

Shelf registration of mortgage-related securities is both easy and economical. The ability to time sales with acquisitions minimizes issuance costs. Moreover, unlike securities sold pursuant to Section 4(5), registered securities are not restricted as to resale.

We support Section 107 of S. 1821. Shelf registration and blind pool formation are essential to facilitate capital formation through sales of mortgage-related securities.

Issues Under the Investment Company Act of 1940

The draftsman of S. 1821 apparently assumed that an issuer of securities exempt under expanded Section 4(5) of the 1933 Act would not be an investment company required to register under the 1940 Act because it would come within the exception from the definition of the term "investment company" provided in Section 3(c)(5)(C) of the Act. That exception covers companies not issuing redeemable securities that are primarily engaged in acquiring mortgages and other liens on and interests in real estate. It is possible, however, that some issuers of securities exempt under expanded Section 4(5) may be required to register as investment companies. */ This

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*/ An issuer of mortgage-related payment bonds would be required to register as an investment company if it invests only in participation interests that are not considered interests in real estate (e.g., interests that do not give the holder the right of foreclosure) or if it invests in such interests to such an extent that its real estate investments cannot be regarded as its primary business. In addition, depending upon how broadly the term mortgage-related payment bond is construed, a trust issuing such a bond may be an investment company. For example, a trust primarily invested in debt obligations of a savings and loan association which are secured by a pledge by the S & L of notes of third parties secured by mortgages of the third parties would, in the absence of special circumstances, be an investment company.

is not necessarily troublesome. As the Subcommittee is aware, the 1940 Act contains provisions tailored specifically to protect the interests of investors in entities that come within the definition of the term "investment company." If the Subcommittee is troubled by the applicability of the 1940 Act, the Commission and its staff would appreciate an opportunity to work with you and your staff in designing provisions to allay your concerns while assuring adequate protection for investors.

* * *

The Commission does not believe that any of the above comments raise serious obstacles to the enactment of S. 1821. Indeed, the Commission is anxious to work with the Subcommittee in resolving any problems with S. 1821 and in encouraging development of a strong private secondary mortgage market.

PROPOSED NEW SECTION 4(5)

(5) Transactions involving one or more promissory notes, participation interests in such notes, or mortgage related payment bonds secured by such notes or participation interests, offered and sold subject to the following conditions:

(A) The note or notes are directly secured by a first lien (or a second lien where the proceeds of the note were applied to the purchase of the security property or to improvements thereon) on—

(i) a single parcel of real estate (includng stock allocated to a dwelling unit in a residential cooperative housing corporation) upon which is located a dwelling or other residential or commercial structure, or

(ii) a residential manufactured home, as defined in section 501(e) of the Depository Institutions Deregulation and Monetary Control Act of 1983;

(B) Such note or notes were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority or were originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 203 and 211 of the National Housing Act; and

(C) The terms of the sale require that:

(i) the minimum aggregate sales price per purchaser be not less than $250,000,

(ii) payment of the sales price by the purchaser be made with cash within 120 days of the date of sale, and

(iii) each purchaser buy only for his own account.

For the purpose of this section only, a mortgage related payment bond means an obligation which, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the above requirements or participation interests therein which are pledged as security for such obligation and which are rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

words "participation interests in" apply only to the promissory notes or also to the words following the word "or," i.e., "mortgage related payment bonds secured by such notes or participation interests." The better interpretation is that the words "participation interests in" apply only to the promissory notes, and that, therefore, participation interests in mortgage-related payment bonds would not be covered by the revised Section 4(5) exemption. It is assumed that this is the correct interpretation in the discussion above. The attached revised draft of Section 4(5) also follows this interpretation. If the version of Section 4(5) in S. 1821 is retained, however, the intent of the bill in this regard should be clarified.

If it is intended that Section 4(5) cover participation interests in mortgage-related payment bonds, the Subcommittee should recognize that the issuer of these securities may be an investment company required to register under the Investment Company Act of 1940 (the "1940 Act"). Mortgage-related payment bonds would be "securities" within the meaning of the 1940 Act. An issuer primarily engaged in investing in them could be an investment company unless by reason of special circumstances the securities are regarded as "mortgages and other liens on and interests in real estate." */

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*/ For example, the Commission's staff has taken the position that an entity that invests in all of the GNMA certificates issued with respect to a pool of mortgages, and which intends to hold all of the certificates, would be regarded as investing in the underlying mortgages.

Public Securities Association
One World Trade Center
New York, New York 10048
(212) 466-1900

PSA

October 12, 1983

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
Senate Dirksen Office Building
Constitution Avenue, N.E.
Washington, D.C. 20510

Dear Senator Garn:

The Public Securities Association's Mortgage-Backed Securities Division strongly supports the objectives of legislative action, like that included in Senate Bills 1821 and 1822, known respectively as the "Secondary Mortgage Market Enhancement Act of 1983" and the "Trust for Investment in Mortgages Act of 1983." Together, these proposals will provide for the removal of many of the statutory and regulatory impediments which have prevented privately issued conventional mortgage-backed securities from becoming a more efficient means of financing residential housing and will foster the creation of a well-balanced mortgage credit distribution system. Moreover, we are of the opinion that both S. 1821 and S. 1822 will significantly enhance the liquidity of savings and loan associations, and will increase significantly the range of institutions which may invest in privately issued mortgage-backed securities.

PSA is the national trade association which represents the banks and securities dealers which underwrite, trade and sell, mortgage-backed securities, U.S. government and federal agency securities and state and municipal securities. Included among our membership of approximately 300 firms are all the leading mortgage-backed securities dealers, many of whom have already individually testified on S. 1821 before the Senate Subcommittee on Housing and Urban Affairs.

It has been estimated that the total mortgage credit need for 1983 could exceed $170 billion. In order to efficiently provide this staggering volume of mortgage credit, the Congress should begin to take steps to promote more efficient means of securitization and sale of mortgage backed securities. Without enactment of legislation like Senate Bills 1821 and 1822 less than half of the 1983's total mortgage credit demand will be provided through securitization. While this figure represents a significant increase from 1982, it is far less than the amount needed to bring true economies of scale to the mortgage credit markets. Over the next decade it has been estimated that $4 trillion dollars will be needed to finance housing in this country. The only way to satisfy this enormous demand for mortgage credit is to encourage private sector access to our nation's capital markets. This can best be accomplished through a mechanism which allows private issuers to efficiently securitize mortgages.

It should also be pointed out that as the secondary mortgage market is made more liquid and efficient we anticipate a narrowing in the yield spreads between mortgage-backed securities and Treasury securities. Lower mortgage interest rates at the origination level should result, significantly benefiting potential home buyers.

We also believe that the development of an efficient and liquid conventional mortgage-backed securities market will be of great assistance to the thrift industry. In our judgment, this legislation will provide the thrifts with a very valuable tool for asset and liability management. To reduce interest rate risk in their future operations, the thrifts will be encouraged to develop more of a mortgage banking attitude to "originate and sell" instead of their traditional attitude of originate and hold. Since conventional mortgage-backed securities will be highly liquid and more marketable than whole loans the thrifts could continue to originate long-term fixed rate mortgages and would be able to securitize them easily, maintaining a high degree of liquidity and consequently reducing the historical mismatch between their long-term assets and short-term liabilities.

For these reasons, we strongly support the objectives of both Senate Bills 1821 and 1822. These proposals will remove many of the legal impediments which have heretofore prevented the development of a larger and more efficient conventional mortgage-backed securities market.

Sincerely,

Edwin F. Payne, Chairman
Mortgage-Backed Securities
Division

EFP:nm

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N.Y. 10271 · (212) 608-1500

EDWARD I. O'BRIEN
President

October 3, 1983

The Honorable Edwin (Jake) Garn
United States Senate
505 Dirksen Senate Ofc. Bldg.
Washington, D.C. 20510

Dear Mr. Chairman:

We appreciate the opportunity to offer our comments on S. 1821, the "Secondary Mortgage Enhancement Act of 1983." The Securities Industry Association represents over 520 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels, as well as the secondary mortgage market.

We endorse the objectives of the bill and believe that the measure would foster the development of an enhanced private secondary mortgage market. However, we have serious reservations relating to certain peripheral issues, not at all necessary to achieving the purposes of the legislation.

Section 105 of the bill would amend the Glass-Steagall Act to permit national (and state chartered) banks to underwrite and deal in mortgage-related securities. We find this provision ill conceived at a time when the Congress is in the midst of grappling with the larger issues of financial institution deregulation. We have advocated a complete review of the Glass-Steagall Act, and its role in today's marketplace. Bank underwriting of private unsecured debt securities, an activity not permitted banks today, would represent a wholesale wrenching of the Glass-Steagall prohibitions without careful, considered deliberation over an issue of great import to our nation's economic fabric. In addition, the Vice President's Task Force on Financial Institution and Regulatory Deregulation has yet to complete its report, which should be considered prior to any redrawing of the lines between varying types of financial institutions. In short, inclusion of this provision is inappropriate when larger issues encompassing the questions raised by this section are under active consideration.

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The Honorable Edwin (Jake) Garn
Page 2
October 3, 1983

Section 107 of the proposed measure would permanently extend shelf registration for these securities. The provision appears to be unnecessary and best left to the Securities and Exchange Commission for resolution. The SEC permitted accelerated registration for mortgage-backed securities by administrative action *prior* to the consideration and temporary adoption of Rule 415. Thus, this enhanced procedure could be available to issuers *without* any congressional sanction for an extension of the shelf registration rule. As the Commission continues to endorse the shelf process for these securities, legislative direction would appear to be somewhat superfluous.

The Securities and Exchange Commission Rule 415, has invited comments from institutions, issuers and underwriters on the efficacy of the Rule during the experimental period. That decision is currently scheduled to be made in November, prior to the expiration of the temporary rule. The SEC currently has ample rulemaking authority to permit shelf registration of mortgage-backed securities if it sees fit to do so. There is no need for the Congress to mandate a particular registration technique and distribution process when that kind of decision has always been left to the SEC.

Should the Congress, after careful deliberation, be determined to direct that shelf registration continue for Section 4(5) securities, we would strongly urge that the provision be crafted narrowly with appropriate legislative language so as to not prejudice the ongoing SEC analysis of Rule 415 for the great bulk of debt and equity offerings.

We urge the Committee to facilitate the entry of private issues to the secondary mortgage market. As we have noted, however, we believe that this can be best accomplished without tampering with extraneous issues, namely Glass-Steagall and shelf registration. These complex issues, each of great significance to the capital formation process, should be considered separately and in detail.

Thank you for the opportunity to submit these comments.

Sincerely,

Edward

EIOB/cem

SENATOR JOHN TOWER IN PRINT

[From The Washington Post, Aug. 20, 1983]

TWO BILLS SEEK TO WIDEN MONEY

(By Kenneth R. Harney)

Two long-awaited pieces of legislation that could expand significantly the amount of mortgage money available to American consumers and cut the cost of home loans have been introduced on Capitol Hill.

Sponsored by the Senate's two top-ranking committee chairmen on banking and housing issues, the bills signal the start of a major congressional effort to widen the money pipeline between home buyers and Wall Street.

Here's what the proposals by Sens. Jake Garn (R-Utah) and John Tower (R-Tex.) would do, and how they could directly affect you as a buyer or seller:

Remove most of the obstacles that discourage pension funds, insurance companies and others from investing in ordinary home mortgages.

Encourage more private firms to go into head-to-head competition with the two government-chartered corporations that have dominated American home financing since the early 1970s, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortagage Corp. (Freddie Mac). Both corporations buy individual loans originated by local lenders in vast quantities. Fannie Mae, for instance, owns $70 billion worth of mortgages—roughly one of every 20 home loans in the country.

Encourage more diversity in the types of mortgages available in the marketplace. Large pools of home loans carrying innovative terms favorable to consumers—but not usually acceptable to large-scale investors—could be packaged and sold to Wall Street under the bills.

Cut the going rate of home mortgages for future buyers by increasing competition within the market and turning on more "money spigots," in the words of one supporter of the bills. Rates on home loans could be sliced by anywhere between one-half and two percentage points, "simply by making mortgages as attractive and convenient as any other type of competing investment" available to an insurance company or other large owner of capital, he said.

The two new bills carry technical-sounding names that would make most consumers' eyes glaze over: the Trust for Investment in Mortgages Act of 1983 (S. 1822) and the Secondary Mortgage Market Enhancement Act of 1983 (S. 1821).

But stripped to their core, the proposals seek to make very basic, bread-and-butter changes in the business of financing homes. The technical amendments that the bills would apply to existing federal laws will allow creation and sale of far greater numbers and varieties of what are known as "mortgage-backed securities." These are pools of hundreds of thousands of loans, packaged into bond-like securities that large capital investors can buy for income.

To picture how these work, imagine that the new mortgages made by banks on all the houses in your city or neighborhood this year were gathered together. The regular monthly payments coming in would make an attractive income—one not only secured by real estate, but carrying a higher return than money-market funds and corporate notes and bonds.

Now let's say those mortgage contracts were put into a package that provided payments on whatever schedule you as an investor wanted: once a year, twice a year, quarterly or monthly. Let's say also that all of the potentially sticky features of individual mortgages were guaranteed to be kept out of your hair: defaults, prepayments, foreclosures and the like.

You could buy into this pool of loans by purchasing a certificate—like a stock or bond—and be relatively certain you'd get the steady return you bargained for. You could buy the entire pool, for that matter, if you had enough bucks. Local lenders would make the mortgages, sell them into pools, and continue to service them indefinitely for a fee.

Although it comes as a surprise to some consumers, this is how more than half of all American home mortgages are financed today. The two new bills on Capitol Hill would speed the movement toward "wholesale" financing even faster. They would give the companies that put together wholesale packages additional powers to manage the cash flows on the loans in the pools. They also probably would stimulate creation of dozens of specialized competitors to Fannie Mae and Freddie Mac such as the new Residential Funding Corp. (RFC) of Minneapolis.

RFC—first previewed in this column last December—specializes in buying so-called "jumbo" home loans above $108,300 and 15-year mortgages. In its first seven months, RFC has committed to finance $1.5 billion worth of jumbo and other loans—mainly the type of mortgages that Fannie Mae and Freddie Mac can't or won't touch because of regulatory restrictions.

The key here is "to open up the mortgage business to even more competiton," said a staff aide on the Senate Banking Committee. "I mean, let's let a thousand flowers bloom. That will mean greater choices for more buyers—and who's going to beef about that?" Garn and Tower will learn the answer to that question on Sept. 21, when they hold two days of hearings on their proposals.

THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

October 23, 1983

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Dear Senator Tower:

The Administration is pleased to support the basic thrust of the Secondary Mortgage Market Enhancement Act of 1983 (S. 1821), as approved by your Committee on October 6, 1983.

The evolving role of the secondary market as a principal source of long-term funds for housing, and the increasing importance of mortgage-backed securities as the principal vehicle through which the secondary market serves as a conduit between capital markets and mortgage markets, was outlined by the President's Commission on Housing and has been fully analyzed and demonstrated in testimony before Senator Tower's Subcommittee on several recent occasions. Equally fully demonstrated is the conclusion, as stated by the President's Commission, that "Greater participation in mortgage investment by private financial institutions with diversified asset portfolios is essential for the broad-based and resilient system of housing finance needed to meet the demands for mortgage credit in the economic environment of the 1980s."

A complementary view arises from a separate perspective. As you know, the Administration, through the Cabinet Council on Economic Affairs, has been conducting a broad review on the role of the two government-sponsored agencies, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), in meeting the Nation's housing finance needs. Two guiding principles have evolved as a result of this view. The first is that, as the FNMA Charter Act itself specifies, the role of these agencies is to provide supplementary assistance to the secondary market, i.e., assistance which the private sector unaided does not furnish. Corollaries of this principle are that expansion of FNMA or FHLMC activities into new or wider markets can only be justified by a clear need for supplementary assistance within that market, and that FNMA and FHLMC activities within any market should be directed at assisting the middle and below level of the market rather than the higher end of the market. The second principle is that it is most desirable over the longer term to foster an atmosphere in which the private sector provides the major share of all financing, in an efficient market-place, without the backing of the Federal Government and without its involvement either in decision-making or risk-taking.

Federal sponsorship of FNMA and FHLMC is in the form of special relationships to the Government that lower their market financing costs compared with completely private borrowers and that assure FNMA's and FHLMC's access to the credit market. FNMA and FHLMC activities appropriately should be focused on serving the middle segment of the housing market and not the upper income market. Furthermore, their authorized activities should not be expanded to incorporate a broader range of activities that are not directly connected to assisting the middle segment of the housing market.

The Administration has long had a commitment to the concept of privatizing the secondary mortgage market, and in the course of deliberations on S. 1821, that goal has been more sharply defined. The primary objective of privatization should be to promote a private secondary market for mortgages without Government involvement in decision-making or risk-taking. This could be accomplished by (1) privatizing the current sponsored agencies by cutting their ties to the Government at some time in the future and (2) promoting conditions for the growth of private sector initiatives.

We recognize that it is not feasible at this time to privatize FNMA and FHLMC completely by discontinuing their special relationships to the Government. Because of FNMA's current financial status, as described more fully below, the immediate severing of all of FNMA's ties to the Federal Government could result in serious financial difficulty for FNMA.

We believe that the most realistic way to achieve meaningful progress toward privatization of the secondary market at this time is to promote private initiatives, while at the same time limiting the activities of FNMA and FHLMC. Private firms, which do not share FNMA's and FHLMC's ties to the Government, are effectively excluded from the market segment that is served by FNMA and FHLMC, because they simply cannot compete with the sponsored agencies in the credit markets. Compared to securities of private issuers, FNMA and FHLMC securities have a 1/2 to 1 point interest rate advantage that directly reflects their agency status.

Several legislative proposals have been under consideration by the Congress in recent months that would expand FNMA asset powers (and, to a lesser degree, those of FHLMC) with the ostensible objective of strengthening their balance sheets to hasten the day when each would become completely private. It should be stressed, however, that many of the expanded asset powers that have been proposed are not related to the charter function of each of these agencies and clearly would be inconsistent with the first principle and its corollaries stated above. They include, for example, removal or liberalization of the current $108,300 ceiling on the dollar amount of mortgages each agency can purchase, granting authority to purchase second mortgages, regardless of the purpose for which the second mortgage was obtained, and entering into other arrangements, such as the financing of shopping centers, that are not directly related to residential mortgages.

FNMA and FHLMC expansion into these credit areas could increase the Federal Government's potential liabilities. While there is no Federal guarantee of the securities of either agency, FNMA is authorized to borrow up to $2.25 billon from the Treasury, at Treasury discretion, while FHLMC has an indirect line to Treasury borrowing through the Federal Home Loan Bank's $4 billion authority to borrow from the Treasury at Treasury discretion.

In the light of the foregoing considerations, we are particularly appreciative and supportive of your resistance against efforts to undo the current mechanisms limiting the maximum one-to-four-family mortgage limits for FNMA and FHLMC. Although the Administration believes that lowering maximum limits could serve as an integral part of the agenda to accomplish privatization, we believe that maintenance of the existing limits of the "conforming" market is essential to the ability to induce private sector firms to enter and grow in the secondary market.

The Administration supports the basic thrust of S. 1821 because it represents an important step toward the creation of a private secondary market capable of meeting the demands of the future. It removes operating obstacles which have disadvantaged private issuers of mortgage-backed securities in relation to governmental or sponsored agency issuers because the latter have been able to avoid them on the basis of the special exemptions which flow from their governmental ties. In its principal provisions Title I is directly responsive to recommendations of the President's Commission on Housing. Furthermore, these provisions are consistent with several changes that the Administration has previously implemented or supported -- particularly changes to shelf registration and ERISA regulations. Thus, the Administration is pleased to endorse Title I of S. 1821 with some specific suggestions on several sections. These are set forth in the section-by-section analysis which is enclosed with this letter.

Much of Title II of S. 1821 grants new authorities or expands existing authorities for FNMA and FHLMC. As stated above, the Administration supports the entrance of more participants into the secondary market. The best way to encourage private participants is to remove existing impediments, as is done in Title I, while at the same time limiting the activities and authorities of FNMA and FHLMC, as is done in Section 203 which we strongly support. Section 206 also is consistent with this approach and we support this provision as well. On the other hand, the Administration does not support Sections 205, 208 and 211 which would expand FNMA's and FHLMC's activities in the secondary market for State-insured mortgages and conventional multifamily mortgages. In addition, for the reasons set forth in the attached section-by-section analysis, the Administration does not support Section 201.

Our views on the provisions of Title II of S. 1821 regarding second mortgages and manufactured home loans have been influenced favorably by revisions made in Committee mark-up which served to relate these authorities more directly to Charter Act purposes. We support Section 204 on the assumption that its authority will continue to be limited to loans secured by manufactured homes which are the principal residence of the borrower. This section should be amended to include a similar principal residence restriction for FNMA purchases. Likewise, we support Section 212 because it limits the use of second mortgage loan proceeds to the purchase of the borrower's principle residence and it includes a sunset provision. This section should be amended to limit the maximum principal amount of all mortgages on a property to the "conforming loan" limit, regardless of what entity holds the first mortgage. With these limitations, these authorities can serve Charter Act functions by producing uniformity and standardization of instruments and market liquidity and depth while minimizing adverse impacts on existing private sector participants in the second mortgage and manufactured home loan secondary markets.

The Administration believes that Congress should receive timely information on FNMA's operations. For example, Congress should be aware of the continuing mismatch between FNMA's asset and liability structures. FNMA ran into financial difficulty beginning in 1980 when its traditional strategy of financing long-term assets with short-term liabilities was the basis of heavy losses. Most prudent businesses would match the maturity of their liabilities as closely as possible against the maturity of their assets, so that on average the portfolio risks would be hedged and profits would be more certain over time. FNMA's asset/liability structure, however, resulted in FNMA being required to refund maturing short-term obligations at interest rates that were sharply higher than yields on older mortgages in its portfolio.

FNMA has a marked-to-market loss on its mortgage portfolio of approximately $8 billion. As of June 30, 1983, FNMA's cost of financing of 11.06 percent exceeded mortgage portfolio earnings of 10.66 percent, which marked the fourteenth consecutive quarter when current mortgage portfolio losses were recorded. Also at the end of June, the average life of FNMA's mortgage portfolio was almost 12 years compared with an average life of 2 years 7 months for FNMA debt obligations. Since the report provision of Section 210 will provide Congress with this kind of information, the Administration supports this provision.

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the submission of this letter to the Committee. We are sending a similar letter to Senator Garn.

Sincerely,

R. T. McNamar
Acting Secretary

The Honorable
John Tower
Chairman, Subcommittee on Housing
and Urban Affairs
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosure

The Administration's Position on S. 1821

Section 101 - Registration Exemption

Section 101 of S. 1821 would enlarge the current exemption registration under the Securities Act of 1933 for certain large real estate transactions provided by Section 4(5) of the 1933 Act by expanding in several respects the securities covered by the exemption, liberalizing the restrictions on sales transactions, and broadening the types of originating institutions. Section 101 has been modified to reflect comments made by the Securities and Exchange Commission (SEC) and the Administration supports this provision, as so modified.

We wish to take note of two comments on Section 101 which have been made by witnesses before the Committee. Certain witnesses recommended reduction of the $250,000 minimum price requirement to $100,000. Others questioned whether the definition of "investment grade" should include the four highest rating categories rather than, for example, the highest two. As pointed out in the SEC's comments, the "investment grade" definition in the bill is consistent with the definition utilized by the Commission in analogous contexts, and we support its retention. The $250,000 minimum threshold is also consistent with the threshold for denoting a sophisticated investor utilized by the SEC in analogous contexts, and we support its retention as well.

Section 102 - Investment by Financial Institutions and National Banks

Section 102 of S. 1821 would allow Federally-chartered financial institutions to invest in mortgage-related securities subject only to limitations prescribed by the Federal Home Loan Bank Board (or, in the case of Federal credit unions, the National Credit Union Administration Board). It also would allow national banks and State-chartered member banks to purchase investment grade mortgage-backed securities. We support enactment of this provision.

Section 103 - Preemption of State Blue Sky and Legal Investment Laws

Section 103 of S. 1821 would preempt State blue sky and legal investment laws so that investment grade mortgage-related securities may be purchased by State-chartered and regulated financial institutions, insurance companies, pension funds, trustees or other regulated entities as if they were government-related securities. States, however, would be authorized to reassert limitations on investment in mortgage securities within three years after enactment of the bill. This section also would provide similar treatment for FNMA and FHLMC issued or guaranteed securities. It is unclear why FNMA and FHLMC need or should receive this preferential treatment and accordingly the Administration does not support extension of this provision to either FNMA or FHLMC.

The Administration fully appreciates the burden on development of a viable private mortgage-backed securities market which results from the fact that many current State provisions were written when mortgage-related securities did not generally exist. The President's Commission on Housing, noting this fact, recommended that "The National Conference of Commissioners on Uniform State Laws should recommend changes to State legal investment statutes to provide authority for investment by regulated fiduciaries in conventional mortgage-backed securities that meet a common set of reasonable investment quality criteria." We recommend that the Committee consider this less intrusive means of recommending changes in State blue sky and legal investment laws.

Section 104 - Shelf Registration

Section 104 of S. 1821 directs the SEC to extend permanently its shelf registration rule for investment grade mortgage-related securities. Shelf registration and blind pool formation are essential to facilitate capital formation through sales of mortgage-related securities. We applaud the administrative reforms already adopted by the SEC in this respect and support enactment of Section 104 of S. 1821.

Section 201 - FHLMC Preferred Stock

Section 201 of S. 1821 would prohibit FHLMC preferred stock from having voting rights but would otherwise permit such preferred stock, when issued to the public, to have "such rights as are permitted by the rules of the New York Stock Exchange in the case of securities listed on such exchange." We understand that this amendment is technical only, intended to limit the characteristics of preferred stock that may be issued by FHLMC which, under Section 306(f) of the FHLMC Act, are unlimited. However, we do not support the issuance of FHLMC preferred stock to the general public so long as FHLMC continues to enjoy the special advantages described as "agency status." Accordingly, we support enactment of subsection (1) of Section 201 but do not support subsection (2) because it would facilitate such a creation of a private equity interest in FHLMC.

Section 202 - FNMA Preferred Stock

Section 202 of S. 1821, by deleting the word "all" from Section 303(a) of the FNMA Charter Act and the word "common" from Section 308(b) of the Charter Act, would permit FNMA to issue preferred stock with voting rights. Section 202 also would require that FNMA preferred stock have such rights as are permitted by the rules of the New York Stock Exchange in the case of securities listed on such exchange. This latter provision would limit the characteristics of FNMA preferred stock which, under current law, are otherwise unlimited (except for the current exclusion of voting rights). Because a private equity interest in FNMA already exists through its common stock ownership, we do not oppose enactment of Section 202 of S. 1821.

Section 203 - Limitations on Participation Agreements by FNMA and FHLMC

Section 203 applies the maximum mortgage limits imposed on FNMA and FHLMC to the total principal obligation of mortgages purchased, not just the portion actually purchased. The Administration supports this section.

Section 204 - FHLMC Manufactured Housing Loans

Section 204 of S. 1821 would extend FHLMC's authority to purchase manufactured home loans where the lien may be considered a lien on personal property rather than real property. As acknowledged by FHLMC in its presentation at the Banking Committee hearing on March 10, 1983, this activity would represent "a significantly different line of business (installment credit) for the corporation." Manufactured housing personal property loans have different characteristics from real property mortgage loans, are underwritten differently, and are sold in an entirely different secondary market. We note, in this connection, that while FNMA's statutory authority, under Section 302(b)(4) of the FNMA Charter Act, to deal in loans secured by "mortgages or other liens against manufactured homes" is not limited to real property mortgage loans, FNMA has never sought to enter the market for manufactured housing personal property loans. (Such a market entry by FNMA would require specific prior approval by the Secretary of HUD).

Thus, this provision would authorize FHLMC entry into a new market area. As noted, a separate, wholly private secondary market for manufactured housing personal property loans now exists. However, manufactured housing represents an important source of affordable housing, and we also recognize the substantial benefits to homeowners which would flow from the uniformity and standardization of instruments, and the consequent increased liquidity of the market, resulting from FHLMC participation. To realize significantly these benefits, while minimizing adverse impacts on existing private sector participants, we support limitation of the authority to loans secured by manufactured homes which are the principal residence of the borrower. We support enactment of Section 204 of S. 1821, and suggest that a provision be added to extend the principal residence limitation to FNMA purchases as well.

Section 205 - FHLMC State Agency Insured Mortgages

Section 205 of S. 1821 clarifies the definition of "conventional mortgage" in the FHLMC Act so that it will include mortgages that are insured by a State agency. The effect of the amendment, therefore, would be to permit FHLMC to recognize such a State agency as a "qualified insurer" for purposes of the statutory requirement that any portion of a conventional loan which exceeds the 80% maximum loan-to-value ratio must be insured. Because we do not see any characteristics peculiar to State-insured mortgages that preclude the private sector from adequately providing a strong secondary market for these mortgages, we oppose adoption of Section 205.

Section 206 - FHLMC Guarantees

Section 206 of S. 1821 would prohibit FHLMC from guaranteeing mortgage-backed securities of other issuers. We understand that FHLMC (unlike FNMA) has contended that it possesses statutory authority to guarantee securities of other issuers, although it has not sought to exercise such authority. We support enactment of Section 206 of S. 1821. In order to remove questions about the effect of this provision, the Administration believes that language should be added that would prohibit FHLMC from guaranteeing any securities issued by others, not solely mortgage-related securities issued by others.

Section 207 - 45-Day Approval Period

Section 207 would require that the Secretary of HUD approve requests from FNMA for "approval or other action" or transmit a report to the Congress explaining why such a request has not been approved within 45 days of submission of the request, subject to a 15-day extension if additional information is requested from FNMA. We understand that this provision is not intended to inhibit the Secretary of HUD from seeking relevant information from sources other than FNMA through such processes as the Secretary of HUD deems appropriate and expedient, including the solicitation of public comment. In many instances the Secretary's decision on FNMA requests may require consideration of factors external to both FNMA and HUD, such as the competitive impact of a proposed FNMA undertaking upon private sector participants in the secondary market, which can be fairly assessed only after obtaining and evaluating additional information from outside sources. The provision would require only that where the Secretary's action on a FNMA request has not been completed within the prescribed period because of such factors, those reasons should be stated in the Secretary's report to Congress. While we have some misgivings regarding this provision and are unable to agree with the judgment that it is necessary, on the basis of the foregoing understanding of its impact we do not object to its enactment.

Section 208 - Multifamily Mortgage Loan-to-Value Ratio

Section 208 eliminates current restrictions on the loan-to-value ratios of multifamily mortgages eligible for purchase by FNMA and FHLMC. Currently, FNMA and FHLMC cannot purchase multifamily mortgages with loan-to-value ratios exceeding 80% unless: 1) the seller retains a 10% participation; 2) the seller agrees to repurchase the mortgage in case of default; or 3) that portion of the mortgage in excess of a 80% loan to value ratio is insured.

FNMA currently does not have an active conventional multifamily mortgage purchase program, although, with HUD permission, it is currently developing a pilot program. We understand that this provision has been requested by FNMA. FHLMC has a currently active multifamily program; nevertheless we understand that it has not requested removal of the loan-to-value restriction.

This section would allow FNMA and FHLMC to expand their purchases of conventional multifamily mortgages to projects without the statutory requirements that FNMA and FHLMC obtain protections against the risks of project default. The Administration does not support the relaxation of current standards designed to protect against defaults. Nor does the Administration believe that the taxpayers should be exposed to the added risk that FNMA or FHLMC would seek funds from the

Treasury as a result of the increased risk exposure in the event of default on multifamily projects. Thus, the Administration opposes Section 208.

Section 209 - Board of Directors

Section 209 expands FNMA's Board of Directors from 15 to 18 members. The Administration does not oppose enactment of this provision.

Section 210 - HUD Annual Report to the Congress on FNMA Activity

Section 210 of S. 1821 would require the Secretary of HUD to report annually to Congress on the activities of FNMA. We understand that the expected scope of this report would be similar to that prescribed previously for a one-time report, viz., the financial operations of FNMA and the extent to which its activities meet the purposes of the Charter Act. The Administration supports enactment of Section 210. We agree, particularly in the light of widespread concerns caused by the financial condition of FNMA in recent periods of high interest rates, that such a continuing reporting requirement is appropriate. Additionally, we believe that it is appropriate that the Administration and the Congress focus attention now on means by which a recurrence of the causes of FNMA's financial difficulties in the early 1980's may be avoided during any future period of similar economic conditions. With this in mind, the Secretary of HUD accepts the request by the Banking Committee for completion and submission of the report on FNMA financial operations mandated by current law.

Section 211 - Increase in Maximum Mortgage Limits for Multifamily Properties

Section 211 of S. 1821 increases FNMA's and FHLMC's maximum mortgage limits for mortgages in high cost areas. Under current law, the maximum principal amount of multifamily mortgages which may be purchased by FNMA or FHLMC is 125% of the applicable FHA limit. Under Section 207(c)(3) of the National Housing Act as in effect prior to passage of the Continuing Appropriations Act of Fiscal Year 1983 (Pub. L. 97-377), the Secretary was authorized to increase the dollar limitations in high-cost areas to 175% of the basic limits. In those areas, therefore, the FNMA and FHLMC limits could be as high as 218.75% of the basic FHA dollar limit (i.e., 125% of 175%). The Continuing Appropriations Act amended Section

207(c)(3) to authorize the Secretary, on a project-by-project basis in high-cost areas, to increase the FHA limits in high cost areas to 240% of the basic FHA limit. Section 210 of S. 1821, by increasing the FNMA and FHLMC limits to 240% of the FHA basic limit in areas designated as high-cost areas by the Secretary of HUD, would raise the limits in such areas to the highest amount which the Secretary could authorize for FHA-insured multifamily mortgages under Section 207.

Section 211 would expand FNMA and FHLMC asset powers by increasing the principal amount of conventional multifamily mortgages purchasable by FNMA and FHLMC in high cost areas. Such expanded asset powers would be contrary to the principle of restricting FNMA and FHLMC activities so that the private sector can have a chance to grow in areas not covered by FNMA and FHLMC. Thus, the Administration opposes Section 210.

Section 212 - Junior Liens

Section 212 of S. 1821 would permit FNMA and FHLMC to purchase or deal in junior lien mortgages other than loans used exclusively for home improvement or energy conservation. It would limit purchases of junior lien mortgages to only those made to assist purchase of a house ("purchase money seconds"), to junior lien mortgages of $50,000 or less, and to properties where the sum of all mortgages purchased by FNMA or FHLMC is less than the maximum mortgage amount. This authority would expire on October 1, 1985. The intent of this provision is to restrict FNMA's recently-granted temporary authority to purchase second mortgages to purchase money seconds below $50,000 and to permit FHLMC temporarily to enter this market.

We believe that the question of whether either of the two sponsored agencies (FNMA or FHLMC) should be authorized to expand its operations into a new market area should be based on the needs of that particular market and, most importantly, the impact of agency entry on existing private sector participants in the market, rather than whether the other agency is already in the market. The Committee has received testimony from previous private sector participants in the secondary market for second mortgages regarding the impact of FNMA market entry on their participation. A growing secondary market composed entirely of private firms existed prior to HUD permission that allowed FNMA to enter the secondary market for junior lien mortgages. Since FNMA's entry, the number of private firms and their share of the market has been substantially reduced. If FHLMC were given the same authorities that FNMA currently has, the remaining private firms who participate in the secondary market for junior lien loans would be driven out by FNMA and FHLMC.

However, because private sector participation in the secondary market for junior lien mortgages has been concentrated in equity seconds -- junior lien mortgages originated at some time after purchase of a property to enable the homeowner to borrow on the equity of the property -- and because purchase money seconds below $50,000 would be used exclusively to assist in the purchase of a home by a low- or middle-income homebuyer, the Administration believes the effect of Section 212 will be to concentrate FNMA and FHLMC activity in markets that are relatively unserved by private participants and that are consistent with FNMA's and FHLMC's charter functions. Addition of a provision requiring that the second mortgage be used for the principal residence would provide additional assurance of this result. Moreover, the use of purchase money seconds as a means of home purchase should decline as interest rates fall. Thus, the Administration supports the temporary authority that permits FNMA and FHLMC to purchase or deal in purchase money seconds under $50,000 with one reservation: the Administration recommends that the limitations set forth in section 212 of S. 1821 be amended to apply to the aggregate amount of all mortgages on the property irrespective of whether any of the other mortgages are purchased, serviced, sold or otherwise dealt with by FNMA or FHLMC. The Administration does suggest reconsideration of one aspect of Section 212. All other authority granted to FNMA under the various subsections of Section 302(b) of the FNMA Charter Act to deal in conventional loans is expressly subject to the approval of the Secretary of HUD. The authority contained in this section would be the only authority excluded from the Secretary's approval. Accordingly, the Administration believes that this authority should be subject to approval by the Secretary of HUD.

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October 31, 1983

Mr. Peter Harkins, Staff Director
Senate Subcommittee on Housing
and Urban Affairs
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Harkins:

You have asked us to comment on Senate Bill 1821, The Secondary Mortgage Market Enhancement Act. We understand that this bill, along with Senate Bill 1822, The Trusts for Investments in Mortgages Act, was recently introduced to foster private sector growth in the mortgage-backed securities market.

Ætna is one of the largest diversified financial organizations, and as such, is a major investor in all financial markets, including the secondary mortgage market. This year alone, we have purchased over $250 million in residential mortgages. We have a total residential mortgage portfolio of $1.5 billion. Accordingly, we have an active interest in any legislation that affects the housing finance market.

We are supportive of the goals and objectives embodied in S.B.1821. The events of the last few years have demonstrated that our country must find ways to increase the capital available for housing finance. The thrifts, which in the past have served as virtually the sole source for residential mortgages, no longer have the capacity to do so. Deregulation has permanently altered their posture in this regard.

Privately-issued mortgaged-backed securities are a key way to help finance the housing purchases of the future. However, the current legal and regulatory constraints on private mortgage-backed securities unnecessarily hamper the future growth of this market to the detriment of many prospective homeowners. S.B.1821, in combination with S.B.1822, should remove many of these constraints, thereby enhancing the acceptability of private mortgage-backed securities to the investment community. As a result, the legislation should result in an expanded capital market to finance home ownership and help to fill the gap left by the thrifts. We believe one key to

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achievement of S.1821's objectives is to retain its concept of "privatization" of the secondary market. We are encouraged that the legislation does not extend to FNMA and FHCMC. We believe their involvement in the TIMs program would greatly discourage the entrance of private organizations into the market.

We have not attempted to comment on specific provisions of S.B.1821. We are reviewing the legislation in detail and may wish at a future date to suggest technical changes. We appreciate the opportunity you have provided us to comment at this time and look forward to working with you as the bill progresses.

Very truly yours,

Ed

Edward E. Sensor

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cc: L. D. Sullivan, Counsel

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